Supreme Court, U. S.
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In The

Supreme Court of the United States

79-66

October Term, 1979

No. A-1068

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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In The

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October Term, 1979

No. A-1068

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioner Peter E. Aaron respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on March 12, 1979.

OPINION BELOW

The opinion of the Court of Appeals, not yet reported, appears in the Appendix hereto. The opinion of the District Court for the Southern District of New York (1977-1978 Transfer Binder) Fed. Sec. L. Rep. (CCH) 96,043 (S.D.N.Y. May 5, 1977), appears in the Appendix hereto.

JURISDICTION

The judgment of the Court of Appeals for the Second Circuit was entered on March 12, 1979. An order extending the time to file this petition for a writ of certiorari was granted on June 11, 1979 to and including July 10, 1979. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Whether the Securities and Exchange Commission is required to establish scienter as an element of a government enforcement action to enjoin violations of §10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and Securities and Exchange Commission Rule 10b-5, 17 CFR §240-10b-5 (1975), or of Section 17a of the Securities Act of 1933, 15 U.S.C. §77q(a).

STATUTORY PROVISIONS INVOLVED

Securities Act of 1933:

> "§17a. Fraudulent Interstate Transactions
>
> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Securities Exchange Act of 1934, §10(b) Manipulative and Deceptive Devices:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase of sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Securities and Exchange Commission Rules:

> "Rule 10b-5 Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange.

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

STATEMENT OF THE CASE[1]

A. Peter Aaron's Responsibilities With E.L. Aaron & Co.

During the period in question, appellant Peter E. Aaron ("Aaron") was employed by E.L. Aaron & Co. ("Aaron & Co." or "the firm"). Aaron & Co. was a broker-dealer registered with the Securities and Exchange Commission ("SEC"). The firm's principal office was in New York City. Aaron's father, Edward L. Aaron, was president and sole shareholder of Aaron & Co.

Aaron had been employed by the firm for 15 years. He served as his father's assistant. He was the firm's trouble shooter and the liaison between the firm's various departments, including operations, sales and the trading room.

Aaron maintained the so-called due diligence files for securities in which the firm made markets. In connection with his supervision of the firm's sales force, Aaron conducted sales

1. The statement of the case is recited *verbatim* from the Second Circuit's opinion.

meetings with registered representatives. At these meetings sales techniques were discussed. He also monitored the registered representatives' trading — by advising them of their monthly production figures, by informing them when any of their clients were late in payment, and by discouraging the representatives from exceeding their individual selling capacities.

As compensation for his services, Aaron received salary, bonuses and expenses at a level comparable to that of his father, the firm's president. Aaron, however, was not registered with the National Association of Securities Dealers ("NASD") as a principal of Aaron & Co. He held no corporate office in the firm.

B. Offer and Sale of Lawn-A-Mat Stock

In November 1974, Aaron & Co. opened a branch in Roslyn Heights, New York. Norman Schreiber, a registered representative of Aaron & Co., was appointed branch manager of the new office. Donald Jacobson, also an Aaron & Co. registered representative, was assigned to assist Schreiber. The Roslyn Heights office was essentially a two-man operation.

From November 1974 through September 1975, Aaron & Co. made a market in the common stock of Lawn-A-Mat Chemical & Equipment Corp. ("LAM"). In doing so, Schreiber and Jacobson contacted stockholders of LAM and its franchise-dealers by phone and by mail to solicit orders for LAM stock. In the course of this promotion, Schreiber and Jacobson made false and misleading statements to prospective purchasers of LAM. Among the statements made were some to the effect that LAM was planning or in the process of manufacturing a new type of small car and a tractor. In fact LAM had no plans to manufacture a car or tractor. Schreiber and Jacobson also made projections of substantial increases in the price of LAM stock and misleading statements about LAM's financial condition.

There was no basis in fact for these projections and statements, since LAM had experienced significant losses during the period involved.

Some of the persons contacted complained to LAM officers about these statements. The LAM officers informed both Schreiber and Jacobson that their statements were false.

When the false and misleading statements continued despite these warnings, LAM's attorney contacted Aaron. He did so twice by telephone during the period involved, informing Aaron of the continuing false and misleading statements by his sales representatives.

Since Aaron was in charge of LAM's due diligence files, he had ample independent reason to know that the information about LAM being disseminated by Schreiber and Jacobson was untrue. Although Aaron notified Jacobson of the LAM attorney's complaint, he did nothing whatsoever to stop the false and misleading statements being made by Schreiber and Jacobson.

C. The Aaron & Co./J. W. Weller & Co./Dorfman Transactions

In November 1974, a representative of Aaron & Co. telephoned Daniel Dorfman, who was then the president, principal stockholder and a director of LAM, to solicit the sale by Dorfman of 1,000 shares of LAM common stock. Since Dorfman was a controlling person of LAM, his shares could not be sold unless registered under §5 of the 1933 Act or unless the sale of the unregistered stock qualified for an exemption from registration pursuant to Rule 144 under the 1933 Act. In view of the fact that Aaron & Co. precipitated the entire transaction by arranging for the sale of shares from Dorfman to Weller and by soliciting customers' buy orders in anticipation of the transfer of

the shares from Weller to Aaron & Co., the sale of the shares to the public obviously did not qualify for a Rule 144 exemption, as we hold below.

In an attempt to enable Aaron & Co. to sell Dorfman's unregistered stock without qualifying for a Rule 144 exemption, the firm arranged the following transaction. Aaron contacted J.W. Weller & Co., Inc. ("Weller"), another broker-dealer, and suggested that Weller act as an intermediary for sales from Dorfman to Aaron & Co. The proposal was that Dorfman would sell his shares to Weller which, as "agent" of the selling shareholder, would sell the shares to Aaron & Co., which in turn would solicit buyers for the shares. Weller agreed. The transaction was consummated. Daniel Dorfman sold 1,000 shares.

Similarly, in February 1975, a representative of Aaron & Co. persuaded Fred Dorfman, who was then vice-president and a director of LAM, to sell 20,000 shares of LAM common stock in the same manner. As with Daniel Dorfman, Fred Dorfman was a controlling person. He was directed to transfer his shares to Weller, which in turn delivered them to Aaron & Co. for public sale.

The SEC commenced the instant enforcement action in the District Court on February 26, 1976. It sought preliminary and final injunctive relief pursuant to §20(b) of the 1933 Act, 15 U.S.C. §77t(b)(1976), and §21(d) of the 1934 Act, 15 U.S.C. §78u(d) (1976). The complaint charged Aaron and three other defendants with violating and aiding and abetting violations of, the registration provisions of §§5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§77e(a) and 77e(c) (1976). The complaint also charged Aaron and seven other defendants with violating, and aiding and abetting violations of, the antifraud provisions of §17(a) of the 1933 Act, 15 U.S.C. §77q(a) (1976), §10(b) of the 1934 Act, 15 U.S.C. §78(b) (1976), and Rule 10b-5 promulgated under the

1934 Act, 17 C.F.R. §240.10b-5 (1978). The seven defendants other than Aaron consented to the entry of permanent injunctions against them.

After a three day evidentiary hearing, the District Court held that Aaron had violated the registration and anti-fraud provisions as charged in the complaint; and that the SEC was entitled to a permanent injunction enjoining Aaron from further such violations.

The judgment rendered by the District Court was affirmed by the Court of Appeals. The Court of Appeals held, in short, that in the context of an enforcement action brought by the SEC to enjoin violations of §10(b), proof of scienter on the part of the defendant is not required. In addition, the Court of Appeals also held "that the SEC was (not) required to prove scienter with respect to that part of this injunction action brought pursuant to §17(a)."

REASONS FOR GRANTING THE WRIT

I.

The decision below conflicts with the decisions of other courts of appeals as to whether scienter is an essential element of a SEC injunction action under Section 10(b) of the Securities Exchange Act of 1934 or of Section 17(a) of the Securities Act of 1933.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that proof of scienter is a necessary element in a private damage action under §10(b). This Court also stated:

> "Since this case concerns an action for damages, we also need not consider the questions whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5.

> Cf. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 11 L at 2d 237, 84 S Ct. 275 (1963)."
> 425 U.S. at 194 n. 12.

In reliance upon its "carefully reasoned pre-*Hochfelder* decisions", the language and history of Section 10b, and the compelling distinction between private damage actions and government injunction actions, the Second Circuit has here held that "the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement actions brought under 10(b) of the 1934 Act and §17(a) of the 1933 Act.

In so holding, the Second Circuit conceded that its interpretation of §10(b) conflicts with that adopted by the Fifth Circuit in *SEC v. Blatt*, 583 F. 2d 1325, 1333 (5th Cir. 1978). Moreover, the Second Circuit conceded that its interpretation of §17(a) conflicts with that adopted by the Seventh Circuit in *Sanders v. John Nuveen & Co.*, 554 F. 2d 790, 795-796 (7th Cir. 1977).

The Second Circuit here found "the language of Section 10(b) alone is not determinative of the issue and that resort to legislative history and purpose is proper."[2] *See* page 15a of the Appendix, *infra*. In discussing the legislative history, the Second Circuit examined §21(d) of the 1934 Act, the explicit statutory provision which authorizes the SEC to bring an injunctive action. The Second Circuit found that Congress expressly indicated at the time of the enactment of §21(d) that SEC injunction actions are exempt from the scienter requirement applicable to private action (17a).

---

2. In *Hochfelder*, at 214, n. 33, this Court stated, "As we find the language and history of §10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of 'policy', set forth by the parties, that may have influenced the lawmakers in their formulation of the statute."

In addition, the Second Circuit held that policy considerations underlying the Securities Acts clearly reflect that a negligence standard should be applied in a government enforcement action (14a). These holdings completely conflict with *Blatt, supra.* There, the Fifth Circuit held that the language and history of §10(b) as analyzed and discussed in *Hochfelder,* conclusively demonstrates that scienter is a necessary element in a government enforcement action. 583 F. 2d 1332. The Fifth Circuit further stated that the language of §10(b) is sufficently clear in its context, and thus controlling, notwithstanding considerations of public policy. 583 F. 2d 1332. Thus, the conflict between the decision below and *Blatt* is complete.[3]

Moreover, the Second Circuit, relying on its discussion of §10(b) and its previous analysis in *SEC v. Coven,* 581 F. 2d 1020, 1026-1028 (2d Cir. 1978), held that scienter is not required in an SEC injunction action under §17(a) (18a-19a). This holding also completely conflicts with the Seventh Circuit's determination in *Sanders v. John Nuveen & Co., Inc., et al.,* 554 F. 2d 790 (7th Cir. 1977). In *John Nuveen & Co., Inc.,* the Seventh Circuit held that for the reasons expressed in *Hochfelder,* scienter is a necessary element under §17(a). 554 F.

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3. The Tenth Circuit has apparently followed the Fifth Circuit in finding that scienter is a necessary element of a government enforcement action. *Edward J. Mawod & Co. v. SEC,* 591 F. 2d 588, 595 (10th Cir. 1979). *See also, SEC v. Willis,*____ F. Supp. ____ (D.D.C. 12/14/78). [Scienter is an essential element of a SEC injunction action under Section 10(b).] *SEC v. Cenco, Inc.,* 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC v. Bausch & Lomb, Inc.,* 420 F. Supp. 1226, 1241 (S.D.N.Y.), *aff'd on different grounds,* 565 F. 2d (2d Cir. 1977).

The First and Ninth Circuits, however, have held that negligence is the appropriate standard in a government enforcement action, *SEC v. World Radio Mission,* 544 F. 2d 535, 541 n. 10 (1st Cir. 1976); *SEC v. Arthur Young & Co.,* No. 77-1768 at 3 (9th Cir. 1979); *see also, SEC v. Geotek,* 426 F. Supp. 715, 726 (N.D. Cal. 1976).

2d 795-796. Thus, the conflict between the decision below and *John Nuveen & Co., Inc.,* is complete.

These conflicts justify the grant of certiorari to review the judgment below.

II.

The decision below raises significant and recurring problems concerning whether the requirement of scienter is applicable to SEC actions to enjoin violations of §10(b) of the 1934 Act and §17(a) of the 1933 Act.

The Second Circuit's opinion in this case addresses itself to the important recurring question concerning the standard of culpability to be employed in enforcement actions by the SEC pursuant to Sections 10(b) and 17(a). In *Ernst & Ernst v. Hochfelder,* 425 U.S. 187, 193 n. 12 (1976) this Court left open the question of the extent to which proof of scienter might be required in injunction actions brought by the SEC. Efforts by the SEC to protect investors through its use of injunctive relief under these sections are common, and both litigants and lower courts urgently need the assistance of this Court in understanding whether scienter is a necessary element in an action for injunctive relief under §10(b) and §17(a). Among the unanswered questions thus posed are:

(1) Whether this Court's analysis and holding in *Hochfelder* concerning the need for an allegation of scienter for a private cause of action for damages under Section 10(b) and Rule 10b-5 applies equally to SEC injunctive proceedings? Clearly, the Second Circuit has held that the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement action brought under §§10(b) and 17(a) On the other hand, the Fifth Circuit in *Blatt,* 583 F. 2d at 1330-1332 felt that "*Hochfelder's* analysis applies forcefully to this issue *sub judice.*"

Obviously, the time has come for this Court to decide the question that it explicitly opened in *Hochfelder*, 425 U.S. 194 n. 12.

(2) Whether the language and history of §10(b) are dispositive of the appropriate standard of liability, or whether the arguments of policy and purpose are compelling?

The Second Circuit believes that the language of §10(b) alone is not determinative of the issue, but that resort to legislative history and purpose is proper. The Fifth Circuit, however, felt no need to look beyond the statute itself. Such a deep division over the standard that the SEC needs to prove in an enforcement action requires attention and resolution by this Court.

(3) Whether Section 17(a) should be read in harmony with *Hochfelder* to require a showing of scienter before an injunction will issue pursuant to that section?

The Second Circuit here also holding that a requirement of scienter is not necessary for SEC injunction actions brought pursuant to §17(a). Again, however, a division exists because the Seventh Circuit in *John Nuveen & Co.*, 554 F.2d 790, has found that scienter is required under §17(a).

It should be noted that this Court's opinion in *Hochfelder* has led many courts and commentators[4] to disagree as to whether scienter is the appropriate requirement in an enforcement action brought by the SEC. Such discussions, coupled with the number of enforcement actions brought by the SEC, underscore the desirability of a thorough examination of the problem by this Court so that litigants and lower courts may properly gauge the proper standard to be applied under §10(b) and §17(a) enforcement actions.

4. *See* Appendix, pages 24a and 26a, *infra*.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Second Circuit.

Respectfully submitted,

s/ Barry M. Fallick

s/ Kenneth J. Platzer

Attorneys for Petitioner

(Counsel for petitioner appreciate the assistance of Sam Rosmarin, a law student, for his aid in preparation of this petition.)

APPENDIX

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 830 — September Term, 1977

(Argued March 3, 1978; finally submitted December 8, 1978 — Decided March 12, 1979)

Docket No. 77-6091

Filed Mar. 12, 1979
A. Daniel Fusaro, Clerk

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

PETER E. AARON,

Defendant-Appellant,

and

E.L. AARON & CO., INC., LAWN-A-MAT CHEMICAL & EQUIPMENT CORP., EDWARD L. AARON, PETER E. AARON, NORMAN LAWRENCE SCHREIBER, DONALD DARWIN JACOBSON, DANIEL DORFMAN, and FERNANDO ERAZO,

Defendants.

Opinion of the United States Court of Appeals for the Second Circuit

BEFORE:

ANDERSON, FEINBERG and TIMBERS, *Circuit Judges.**

Appeal from a permanent injunction entered after an evidentiary hearing in the Southern District of New York, Lee P. Gagliardi, *District Judge,* [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,043 (S.D.N.Y. May 5, 1977), enjoining Peter E. Aaron from violating the registration and antifraud provisions of the federal securities laws, the other seven named defendants having consented to the entry of permanent injunctions against them.

Affirmed.

Paul Gonson, Associate General Counsel, Securities and Exchange Commission, Washington, D.C. (Harvey L. Pitt, General Counsel, Jacob H. Stillman, Assistant General Counsel, Angela M. Desmond and Glynn L. Mays, Attorneys, Securities and Exchange Commission, Washington, D.C., on the brief), *for plaintiff-appellee.*

Bert L. Gusrae, New York, N.Y. (John Lowy, and Gusrae, Greene & Kaplan, New York, N.Y., on the brief), *for defendant-appellant.*

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* Pursuant to §0.14 of the Rules of this Court, this appeal is being determined by Judges Feinberg and Timbers who are in agreement on this opinion. Judge Anderson, who heard the argument, unfortunately died on May 2, 1978. Prior to his death, Judge Anderson voted to affirm and was in agreement with his colleagues on all issues in the case. He did not have the opportunity, however, to see this opinion prior to his death.

Opinion of the United States Court of Appeals for the Second Circuit

TIMBERS, *Circuit Judge:*

On this appeal from a permanent injunction entered after an evidentiary hearing in the Southern District of New York, Lee P. Gagliardi, *District Judge,* [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,043 (S.D.N.Y. May 5, 1977), enjoining Peter E. Aaron from violating the registration and antifraud provisions of the federal securities laws, we find the following to be the essential issues presented:

(1) Whether the district court erred in holding that Aaron's managerial and supervisory responsibilities with a broker-dealer firm, despite his lack of corporate title, made him subject to a permanent injunction enjoining him from violating the registration and antifraud provisions of the federal securities laws.

(2) Whether the district court erred in holding that Rule 144 under the 1933 Act does not provide an exemption from the registration provisions of that Act for controlling persons who sold shares, allegedly pursuant to Rule 144, to a broker who then sold them to a second broker for public sale without compliance with Rule 144.

(3) Whether the district court erred in holding that the SEC is not required to establish scienter as an element of a government enforcement action to enjoin violations of §10(b) of the 1934 Act or of §17(a) of the 1933 Act.

(4) Whether the district court erred in granting the permanent injunction under all the circumstances of this case.

For the reasons below, we agree in all respects with the district court's holdings on the essential issues stated above and we affirm in its entirety the permanent injunction as entered.

I.

We assume familiarity with Judge Gagliardi's excellent district court opinion. We accept his adequate findings of fact, Fed. R. Civ. P. 52(a), and we agree with his conclusions of law. We summarize here only those facts necessary to an understanding of our rulings on the legal issues stated above.

(A) *Peter Aaron's Responsibilities With E.L. Aaron & Co.*

During the period in question, appellant Peter E. Aaron ("Aaron") was employed by E.L. Aaron & Co. ("Aaron & Co." or "the firm"). Aaron & Co. was a broker-dealer registered with the Securities and Exchange Commission ("SEC"). The firm's principal office was in New York City. Aaron's father, Edward L. Aaron, was president and sole shareholder of Aaron & Co.

Aaron had been employed by the firm for 15 years. He served as his father's assistant. He was the firm's trouble shooter and the liaison between the firm's various departments, including operations, sales and the trading room.

Aaron maintained the so-called due diligence files for securities in which the firm made markets. In connection with his supervision of the firm's sales force, Aaron conducted sales meetings with registered representatives. At these meetings sales techniques were discussed. He also monitored the registered representatives' trading — by advising them of their monthly production figures, by informing them when any of their clients were late in payment, and by discouraging the representatives from exceeding their individual selling capacities.

As compensation for his services, Aaron received salary, bonuses and expenses at a level comparable to that of his father, the firm's president. Aaron, however, was not registered with the National Association of Securities Dealers ("NASD") as a principal of Aaron & Co. He held no corporate office in the firm.

(B) *Offer And Sale Of Lawn-A-Mat Stock*

In November 1974, Aaron & Co. opened a branch in Roslyn Heights, New York. Norman Schreiber, a registered representative of Aaron & Co., was appointed branch manager of the new office. Donald Jacobson, also an Aaron & Co. registered representative, was assigned to assist Schreiber. The Roslyn Heights office was essentially a two-man operation.

From November 1974 through September 1975, Aaron & Co. made a market in the common stock of Lawn-A-Mat Chemical & Equipment Corp. ("LAM"). In doing so, Schreiber and Jacobson contacted stockholders of LAM and its franchise-dealers by phone and by mail to solicit orders for LAM stock. In the course of this promotion, Schreiber and Jacobson made false and misleading statements to prospective purchasers of LAM. Among the statements made were some to the effect that LAM was planning or in the process of manufacturing a new type of small car and a tractor. In fact LAM had no plans to manufacture a car or tractor. Schreiber and Jacobson also made projections of substantial increases in the price of LAM stock and misleading statements about LAM's financial condition. There was no basis in fact for these projections and statements, since LAM had experienced significant losses during the period involved.

Some of the persons contacted complained to LAM officers about these statements. The LAM officers informed both Schreiber and Jacobson that their statements were false.

When the false and misleading statements continued despite these warnings, LAM's attorney contacted Aaron. He did so twice by telephone during the period involved, informing Aaron of the continuing false and misleading statements by his sales representatives.

Since Aaron was in charge of LAM's due diligence files, he had ample independent reason to know that the information about LAM being disseminated by Schreiber and Jacobson was untrue. Although Aaron notified Jacobson of the LAM attorney's complaint, he did nothing whatsoever to stop the false and misleading statements being made by Schreiber and Jacobson.

(C) *The Aaron & Co./J.W. Weller & Co./Dorfman Transactions*

In November 1974, a representative of Aaron & Co. telephoned Daniel Dorfman, who was then the president, principal stockholder and a director of LAM, to solicit the sale by Dorfman of 1000 shares of LAM common stock. Since Dorfman was a controlling person of LAM, his shares could not be sold unless registered under §5 of the 1933 Act or unless the sale of the unregistered stock qualified for an exemption from registration pursuant to Rule 144 under the 1933 Act. In view of the fact that Aaron & Co. precipitated the entire transaction by arranging for the sale of shares from Dorfman to Weller and by soliciting customers' buy orders in anticipation of the transfer of the shares from Weller to Aaron & Co., the sale of the shares to the public obviously did not qualify for a Rule 144 exemption, as we hold below.

In an attempt to enable Aaron & Co. to sell Dorfman's unregistered stock without qualifying for a Rule 144 exemption, the firm arranged the following transaction. Aaron contacted J.W. Weller & Co., Inc. ("Weller"), another broker-dealer, and suggested that Weller act as an intermediary for sales from Dorfman to Aaron & Co. The proposal was that Dorfman would sell his shares to Weller which, as "agent" of the selling shareholder, would sell the shares to Aaron & Co., which in turn would solicit buyers for the shares. Weller agreed. The transaction was consummated. Daniel Dorfman sold 1,000 shares.

Similarly, in February 1975, a representative of Aaron & Co. persuaded Fred Dorfman, who was then vice-president and a director of LAM, to sell 20,000 shares of LAM common stock in the same manner. As with Daniel Dorfman, Fred Dorfman was a controlling person. He was directed to transfer his shares to Weller, which in turn delivered them to Aaron & Co. for public sale.

The SEC commenced the instant enforcement action in the district court on February 26, 1976. It sought preliminary and final injunctive relief pursuant to §20(b) of the 1933 Act, 15 U.S.C. §77t(b)(1976), and §21(d) of the 1934 Act, 15 U.S.C. §78u(d) (1976). The complaint charged Aaron and three other defendants with violating and aiding and abetting violations of, the registration provisions of §§5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§77e(a) and 77e(c) (1976). The complaint also charged Aaron and seven other defendants with violating, and aiding and abetting violations of, the antifraud provisions of §17(a) of the 1933 Act, 15 U.S.C. §77q(a) (1976), §10(b) of the 1934 Act, 15 U.S.C. §78(b) (1976), and Rule 10b-5 promulgated under the 1934 Act, 17 C.F.R. §240.10b-5 (1978). The seven defendants other than Aaron consented to the entry of permanent injunctions against them.

After a three day evidentiary hearing, Judge Gagliardi on May 5, 1977 filed a comprehensive, well reasoned opinion, holding that Aaron had violated the registration and anti-fraud provisions as charged in the complaint; and that the SEC was entitled to a permanent injunction enjoining Aaron from further such violations.

From the final judgment entered on Judge Gagliardi's opinion, the instant appeal has been taken.

II.

In the light of these facts and prior proceedings, we turn first to the question whether Aaron, despite his lack of official title, was properly enjoined pursuant to §20(b) of the 1933 Act and §21(d) of the 1934 Act[1] from violating the registration and antifraud provisions of the federal securities laws — on the basis of violations committed by the brokerage firm's registered representatives. We hold that, because Aaron exercised managerial and supervisory authority over the firm, he was equally responsible for the fraudulent representations made by the firm's salesmen. The permanent injunction was properly entered against him.

Several courts have held the managerial and supervisory personnel who held official title in a broker-dealer firm have a duty to prevent or halt actions by firm employees in violation of the federal securities laws. *See, e.g., Gross v. SEC,* 418 F.2d 103 (2 Cir. 1969) (Moore, J.); *Stevens v. Abbott, Proctor & Paine,* 288 F. Supp. 836, 847 (E.D. Va., 1968). The presence or absence of an official title, however, has not been a decisive factor in determining liability. Thus, in *Gross v. SEC, supra,* we affirmed a decision by the Commission holding that the vice-president of a broker-dealer was liable under §10(b) of the 1934 Act and

§17(a) of the 1933 Act for aiding and abetting actions by the firm and its employees which were found to be in violation of the antifraud provisions of the Acts. Although Gross held the official title of vice-president, Judge Moore did not focus on his status as an officer, but instead emphasized his "participation in the management of the firm." 418 F.2d at 107.

This is not the only context in which our decision has turned on a defendant's functions within the firm, rather than on his corporate title. In *Colby v. Klune,* 178 F.2d 872, 873 (2 Cir. 1949), we held that the absence of an official title does not preclude liability under §16(b) of the 1934 Act, 15 U.S.C. §78p(b) (1976). We held that the term "'officer'" as used in §16(b) should be interpreted in light of the duties performed by the particular corporate employee and that "[i]t is immaterial how his functions are labelled." 178 F.2d at 873. Similarly, in *SEC v. Galaxy Foods, Inc.,* 417 F. Supp. 1225, 1247 (E.D.N.Y. 1976), *aff'd mem.,* 556 F.2d 559 (2 Cir.), *cert. denied,* 434 U.S. 855 (1977), the district court, in granting injunctive relief, emphasized the defendants' involvement in the firm's actions rather than their official status within the firm.

Appellant here claims that his lack of corporate title insulates him from liability based on the actions of the firm's employee. This claim, if upheld, would seriously undermine the purposes of the antifraud provisions of the securities laws and deprive customers of brokerage firms of the protections which they expect when dealing with professionals in the industry. As the Supreme Court observed in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 203 (1976), §10(b) of the 1934 Act was designed as a "catch-all clause" to enable the Commission to deal with new manipulative devices. Courts have been extremely flexible in interpreting the requirements of this section.

Consistent with this pragmatic approach, we hold that appellant's lack of corporate title does not foreclose the entry against him of a permanent injunction based on the clearly fraudulent activities of the firm's representatives.[2] The district court found that, while Aaron never registered as a principal with the NASD[3] nor held an official title at Aaron & Co., he participated in management decisions, monitored the trading of the firm's representatives, and, with his father, exercised supervisory responsibilities over the firm's employees. *SEC v. E.L. Aaron & Co., Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,043 at 91,684 (S.D.N.Y. May 5, 1977). Moreover, the evidence clearly supports the district court's finding that Aaron had supervisory responsibilities over the Roslyn Heights branch office.

Based on his participation in the management of the firm and his supervisory responsibilities, we hold that Aaron aided and abetted the violations by the firm's salesmen and therefore is subject to a permanent injunction. To permit the management of broker-dealers to avoid the consequences of their supervisory responsibilities and thus to escape injunctive and other liability imposed upon them by the antifraud provisions of the federal securities laws merely because they lack corporate title, would create a particularly vacuous and pernicious distinction. We decline to do so.

III.

We turn next to the question whether, under Rule 144,[4] the sale of unregistered LAM stock by controlling persons of LAM to Weller & Co., and ultimately to Aaron & Co. for resale to the public, is exempt from the registration requirements of §5 of the 1933 Act.[5] We hold that this sham transaction is not exempt under Rule 144.

Section 5 of the 1933 Act, read in conjunction with §§4(1) and 2(11) of the 1933 Act,[6] prohibits the issuer of any security or controlling persons of the issuer from selling or offering to sell a security in interstate commerce unless a registration statement is in effect. The registration statement is designed to assure public access to material facts bearing on the value of publicly traded securities and is central to the Act's comprehensive scheme for protecting public investors. *See generally, SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1952). Accordingly, any exemption from this requirement must be strictly construed. *Milnarik v. M-S Commodities, Inc.*, 320 F. Supp. 1149, 1151 (N.D. Ill. 1970), *aff'd*, 457 F.2d 274 (7 Cir.) (Stevens, J.), *cert. denied*, 409 U.S. 887 (1972). *See SEC v. Ralston Purina Co., supra*, 346 U.S. at 126; *SEC v. North American Research & Development Corp.*, 424 F.2d 63, 71-72 (2 Cir. 1970).

Two such exemptions are those provided for in §4(4) of the 1933 Act, 15 U.S.C. §77d (1976), and in Rule 144. Section 4(4) provides an exception from registration for "brokers, transactions executed upon customers orders . . . but not the solicitation of such orders." The Commission in Rule 144 has clarified the meaning of "brokers' transactions" by defining them to encompass only transactions where a broker

> "(1) Does no more than execute the order or orders to sell the securities *as agent* for the person for whose account the securities are sold; . . . .
>
> (2) Neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; . . ." (emphasis added). Rule 144(g), 17 C.F.R. §230.144(g) (1978).

Appellant argues that these exemptions are applicable to the Dorfmans' sale of LAM stock to Weller & Co. and the subsequent sale to Aaron & Co. and, therefore, that registration was not required. We disagree.

It is clear that, if Aaron & Co. had purchased the Dorfmans' shares directly from the Dorfmans and then had attempted to sell such shares to the public, with all other circumstances remaining the same, the transaction would have failed to comply with the exemption requirements for two reasons. First, with respect to the sale of LAM shares by the Dorfmans, Aaron & Co. solicited the sale of LAM shares with an eye to acquiring the shares for its own account; thus, Aaron & Co., by acting as *principal* for its own account rather than as *agent* of the seller, would not have complied with the requirement of Rule 144(g)(1). Second, Aaron & Co., by engaging in the solicitation of customers' orders to buy LAM shares in anticipation of the Dorfman sale, would have failed to comply with §4(4) and Rule 144(g)(2).

Aaron & Co., however, did not purchase the shares directly from the Dorfmans. In order to circumvent the restrictions of Rule 144 and §4(4), Aaron & Co. concocted a scheme which called for interposing another brokerage firm — Weller & Co. — to act as middlemen in the transaction Weller & Co. would purchase the shares from the Dorfmans and then, pursuant to a prearranged agreement, would resell the shares to Aaron & Co. Although the scheme clearly was an attempt to obfuscate the true nature of the transaction and to evade the intent of the exemption restrictions, appellant nevertheless argues that the transaction technically complied with the Rule.

We hold that the fact that Aaron & Co. did not purchase the shares directly from the controlling persons is inconsequential. Aaron & Co. still precipitated the entire

transaction. They solicited the sale of shares from the Dorfmans in violation of Rule 144(g)(1). They determined the price. They introduced the Dorfmans to Weller & Co. and arranged for the sale of shares from the Dorfmans to Weller & Co. and then from Weller & Co. to Aaron & Co. Moreover, they solicited customers' buy orders in anticipation of the acquisition of the Dorfmans' unregistered shares. If we were to sanction this obviously sham transaction, we would be undermining the statutory requirement of registration when securities are transferred from controlling persons into the market. We decline to do so. We hold that the transaction failed to comply with the restrictions of Rule 144 and §4(4).[7]

IV.

We turn next to appellant's claim that the district court erred in holding that the SEC is not required to establish scienter as an element of a government enforcement action to enjoin violations of §10(b) of the 1934 Act or of §17(a) of the 1933 Act.

(A) *Section 10(b) of the 1934 Act.*

In *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), the Court held that proof of scienter is a necessary element in a private damage action under §10(b).[8] The Court, however, explicitly left open the question whether scienter would be required in future injunction actions. 425 U.S. at 194 n. 12. In granting the permanent injunction below, the district court found that appellant's conduct in connection with the misleading statements was sufficient to establish scienter.[9] Nevertheless, we find it unnecessary to reach the question whether Aaron's conduct would support a finding of scienter, since we hold that the scienter requirement enunciated in *Hochfelder* is not

applicable to government enforcement actions brought under §§10(b) and 21(d) of the 1934 Act. Consistent with the pre-*Hochfelder* decisions of this Court, we continue to hold that allegations and proof of negligence alone will suffice, for the reasons stated below.

Although various courts[10] and commentators[11] have examined the question of what degree of culpability is required for injunction actions after *Hochfelder*, we have not had the occasion to rule squarely on that issue to date.[12] Accordingly, our analysis must begin with the reasoning of the Supreme Court in *Hochfelder* itself.

In holding that scienter is required for private damage actions under §10(b), the Supreme Court in *Hochfelder* relied on three factors: (1) the language of §10(b); (2) the legislative history of the 1934 Act; and (3) the relationship of §10(b) to the other express civil remedies[13] and the effect of a scienter requirement on the overall statutory scheme of the securities laws. Looking first to the language of §10(b), the Court observed that the use of the words "manipulative" and "deceptive" in conjunctive with "device or contrivance" indicated an intent to proscribe "only knowing or intentional misconduct." 425 U.S. at 197. Examination of the legislative history of §10(b) and its relationship to other provisions of the securities laws reinforced the Court's conclusion that scienter was required for private damage actions under §10(b). *Id.* at 201-211.

It has been suggested that the analysis employed in *Hochfelder* should apply with equal force to the question of scienter as a requisite element in a government injunction action. *SEC v. Blatt*, 583 F.2d 1325, 1333 (5 Cir. 1978). *See also Ernst & Ernst v. Hochfelder, supra*, 425 U.S. at 217 (Blackman, J., dissenting — "the question whether negligent conduct violates the Rule should not depend upon the plaintiff's identity.") For

the reasons below and especially in the light of the carefully reasoned pre-*Hochfelder* decisions of this Court, we believe that there are compelling distinctions between private damage actions and government injunction actions so far as the scienter requirement is concerned.

Long before the Supreme Court's holding in *Hochfelder*, our Court had construed the language of §10(b) to require scienter in the context of private damage actions. *See, e.g., Lanza v. Drexel*, 479 F.2d 1277, 1301, 1305-06 (2 Cir. 1973) (en banc); *Shemtob v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2 Cir. 1971); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 868 (2 Cir. 1968) (en banc) (Friendly, J., concurring), *cert. denied*, 394 U.S. 976 (1969). On the other hand, we uniformly have held that the language and history of the section did not require a showing of scienter in an injunction enforcement action brought by the Commission. *See, e.g., SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 809 (2 Cir. 1975); *SEC v. Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1096 (2 Cir. 1972); *Hanly v. SEC*, 415 F.2d 589, 596 (2 Cir. 1969); *SEC v. Texas Gulf Sulphur Co., supra*, 401 F.2d at 854. In view of the policy considerations underlying the securities acts, it has been our view that the increased effectiveness of government enforcement actions predicated on a showing of negligence alone outweighed the danger of potential harm to those enjoined from violating the securities laws. *See, e.g., SEC v. Spectrum, Ltd.*, 489 F.2d 535, 541-42 (2 Cir. 1973); *SEC v. Texas Gulf Sulphur Co., supra*, 401 F.2d at 854-55, 868. Our decisions uniformly have held that a negligence standard should be applied in a government enforcement action because such actions are brought for the purpose of providing maximum protection for the investing public, as contrasted with the purpose of private damage actions which are brought to obtain monetary relief for individual investors. *See SEC v. Manor Nursing Centers, Inc., supra;*

Hanly v. SEC, supra. This distinction was succinctly stated in our recent decision in *SEC v. Coven,* 581 F.2d 1020, 1027-28 (2 Cir. 1978) (Mansfield, J.):

> "The essential nature of an SEC enforcement action is equitable and prophylactic; its primary purpose is to protect the public against harm, not to punish the offender."

The Court's decision in *Hochfelder* in our view has not altered the fact that different policy considerations should govern in SEC enforcement actions, in contrast to private damage actions, under §10(b). Indeed, the Court itself appears to have recognized this when it expressly left open the question now before us. 425 U.S. at 194 n.12.

Moreover, an examination of the same three factors that the Supreme Court relied on in concluding that scienter is required for private damage actions under §10(b) indicates to us that scienter should not be required in a government enforcement action.

The first factor — the language of §10(b) — of course is the same regardless of whether the action is brought by the SEC or a private individual. Contrary to appellant's assertions, however, we do not believe that the language of the section alone is determinative of the issue. As the judicial interpretation of the section demonstrates, different courts have construed the language differently. *See* The Supreme Court, 1975 Term, *supra* note 8, at 258 & n. 35; Note, 77 Colum. L. Rev., *supra* note 11, at 425 n. 43. Where the statutory language is unclear, the Supreme Court has held that resort to legislative history and purpose is proper. *See, e.g., Train v. Colorado Public Interest Research Group,* 426 U.S. 1, 10 (1976); *Cass v. United States,*

417 U.S. 72, 78 (1974); *Perry v. Commerce Loan Co.,* 383 U.S. 392 (1966); *NLRB v. Fruit & Vegetable Packers,* 377 U.S. 58, 62 (1964); *Cox v. Roth,* 348 U.S. 207, 209 (1955); *United States v. Rosenblum Truck Line Association,* 315 U.S. 50 (1942).

As the Court stated in *Hochfelder,* however, the legislative history of §10(b) is "bereft of any explicit explanation of Congress' intent." 425 U.S. at 201. Pointing out that the 1934 Act as a whole was aimed at clearly intentional fraud, the Court nevertheless concluded, in the context of an implied right of action for damages, that the legislative history of the section did not conflict with the conclusion the Court reached through textual analysis of the section.

The Court in *Hochfelder* was dealing with the question of a judicially implied right of action as to which it is not surprising that there was very little legislative history on the scienter issue. In the past, our Court has looked for guidance in defining the requirements for a private right of action under §10(b) to the common law of misrepresentation and deceit. *Lanza v. Drexel, supra,* 479 F.2d at 1291-93, 1306. In defining the requirements for an SEC injunction action based on violations of §10(b), however, we have looked to §21(d) formerly §21(e) of the 1934 Act, the explicit statutory provision which authorizes the SEC to bring such an action. *See SEC v. Texas Gulf Sulphur Co., supra,* 401 F.2d at 855 & n.21.

Legislative discussion of §21(d) indicates that scienter was not intended to be required in SEC injunction actions.[14] The predecessor of §21(d) — §21(e) of the 1934 Act, 15 U.S.C. §78u(e) (1970) — provided for an injunction action to be brought by the SEC "[w]henever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of any rule or

regulation thereunder. . . ." When §21(e) was replaced by §21(d), at the time of the enactment of the Securities Acts Amendments of 1975, 15 U.S.C. §78u(d) (1976), Congress expressly indicated its approval of the approach taken by our Court with regard to injunction actions brought under §10(b):

> "Private actions frequently will involve more parties and more issues than the Commission's enforcement action, thus greatly increasing the need for extensive pretrial discovery. In particular, issues related to matters of damages, such as scienter, causation and the extent of damages, are elements *not* required to be demonstrated in a Commission injunctive action." (citation omitted) (emphasis in original). S. Rep. No. 75, 94 Cong., 1st Sess. 76 (1975).

It would be difficult to find a clearer indication, at the time of the enactment of §21(d), that Congress intended to exempt SEC injunction actions from the scienter requirement applicable to private actions.

Finally, we are satisfied that rejection of a scienter requirement for SEC injunction actions is consistent with the overall enforcement scheme of the securities acts. The *Hochfelder* holding reflected the Court's concern that the absence of a scienter requirement for private damage actions under §10(b) would render superfluous the statutory scheme of "express civil remedies" and would "significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions." 425 U.S. at 214 n.33. Such concerns strike us as not applicable to SEC enforcement actions. An examination of the statutory scheme indicates that there are no comparable

provisions which would be nullified by permitting SEC enforcement actions to be predicated on a showing of negligence. Indeed, to sanction §10(b) injunctive relief on proof of negligence would be to harmonize the requirements of that section with the standards governing similar prophylactic provisions of the 1933 Act.[15]

We reject appellant's contention that a permanent injunction was erroneously entered against him under §10(b) because his actions failed to support a finding of scienter. We hold that, in the context of an enforcement action brought by the SEC to enjoin violations of §10(b), proof of scienter on the part of the defendant is *not* required.[16]

(B) *Section 17(a) of the 1933 Act.*

Appellant also contends that the holding in *Hochfelder* requires a finding of scienter for SEC injunction actions brought pursuant to §17(a) of the 1933 Act, 15 U.S.C. §77q(a). It follows from our holding above under §10(b) of the 1934 Act that a fortiori scienter is not a requisite element of a government enforcement action to enjoin violations of §17(a) of the 1933 Act.

While courts in other circuits since *Hochfelder* have divided on whether the holding in *Hochfelder* should apply to actions brought under §17(a),[17] the rule in this Circuit, as carefully enunciated by Judge Mansfield in *SEC v. Coven, supra,* 581 F.2d at 1026-28, unequivocally is that scienter is *not* required in an SEC injunction action under §17(a). Focusing on the absence of any terminology in §17(a) comparable to the words "manipulative or deceptive" "device" or "contrivance" which the Court found persuasive in *Hochfelder,* our Court in *Coven* held that "we see no reason to give §17(a) a similarly narrow reading." *Id.* at 1026-27.

We agree and accordingly we reject appellant's claim that the SEC was required to prove scienter with respect to that part of this injunction action brought pursuant to §17(a).

V.

Finally, we must consider whether, under all of the circumstances of this case, the district court erred in granting a permanent injunction enjoining Aaron from future violations of the securities laws.

This Court consistently has held — over a period of two decades — that the district court has broad discretion to enjoin possible future violations of the securities laws when past violations have been shown and this determination will not be disturbed on appeal unless it is clearly shown that the district court abused its discretion. *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1100; *SEC v. Texas Gulf Sulphur Co., supra,* 446 F.2d at 1306-07; *SEC v. Culpepper,* 270 F.2d 241, 250 (2 Cir. 1959). *See United States v. W.T. Grant Co.,* 345 U.S. 629, 633 (1953). The critical question in determining whether the public interest requires the imposition of a permanent injunction is "whether there is a reasonable likelihood that the wrong will be repeated." *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1100. *Accord, SEC v. Management Dynamics, Inc.,* 515 F.2d 801, 807 (2 Cir. 1975).

It is well established that the commission of past fraudulent conduct gives rise to an inference that continued violations may be expected in the future. *SEC v. Management Dynamics, Inc., supra,* 515 F.2d at 807; *SEC v. Manor Nursing Centers, Inc., supra* 458 F.2d at 1100. In making its determination, the district court properly considered such factors as the nature of appellant's past violations, *United States v. W.T. Grant Co.,*

supra, 345 U.S. at 633, and the fact that appellant continues to maintain that his conduct was lawful and innocent. *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1101. *Accord, SEC v. Commonwealth Chemical Securities, Inc.,* 574 F.2d 90, 100 (2 Cir. 1978); *SEC v. Universal Major Industries,* 546 F.2d 1044, 1048 (1976). Not only did appellant permit the two salesmen of the firm to engage in fraudulent activities for five months after he had been informed of their false and misleading representations, but he continues to adhere to the position that he had no supervisory responsibilities over them because of his lack of title in the firm. The district court also found that appellant was responsible for arranging the sham transaction for the sale of the Dorfmans' shares in an attempt to circumvent the restrictions of Rule 144.

In addition to the foregoing factors which alone are sufficient to justify a permanent injunction, the district court found that appellant had acted with scienter in committing the violations charged. While we have held that scienter is not a requisite element of a SEC injunction action under §10(b) or §17(a), the court's findings that appellant acted with scienter underscore the need for an injunction. *SEC v. Commonwealth Chemical Securities, Inc., supra,* 574 F.2d at 100; *SEC v. Universal Major Industries, supra,* 546 F.2d at 1048.

Accordingly, we hold that the district court properly exercised its discretion in granting the permanent injunction enjoining appellant from committing further violations of the securities laws.[18]

Affirmed.

FOOTNOTES

1] Section 20(b) of the 1933 Act, 15 U.S.C. §77t(b) (1976), provides in relevant part:

> "Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion, bring an action in any district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond."

Section 21(d) of the 1934 Act, 15 U.S.C. §78u(d)(1976), provides in relevant part:

> "Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder . . . it may in its discretion bring an action in the proper district court of the United States . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond."

2] The district court found that two of the firm's registered representatives made a number of serious and blatant misrepresentations to Aaron & Co. customers concerning

aspects of LAM's activities and financial condition. With the exception of certain statements regarding LAM's plans to build a car and tractor, appellant does not dispute that these false statements were made. He does contend, however, that there was insufficient evidence to support the district court's finding that LAM was not manufacturing a car or tractor and did not plan to do so. After reviewing the record, we hold that the district court's finding was not clearly erroneous, Fed. R. Civ. P. 52(a), but indeed was supported by the evidence.

3] Appellant contends that since he was not registered as a principal with the NASD, he can not be held liable for violations at an office already managed by a registered principal. In view of our holding that a defendant's liability depends upon the extent and nature of his responsibilities and not on his title, we hold that the district court properly rejected appellant's contention. Moreover, we find no error in the court's refusal to receive in evidence an exchange of certain letters relating to Aaron's need to register with the NASD. In view of our holding, these letters were irrelevant to the issue of whether Aaron aided and abetted violations of the securities laws.

4] 17 C.F.R. §230.144 (1978).

5] 15 U.S.C. §77e (1976).

6] Section 4(1) of the 1933 Act, 15 U.S.C. §77d(1) (1976), makes §5 inapplicable to transactions by anyone "other than an issuer, underwriter or dealer." Section 2(11) of the 1933 Act, 15 U.S.C. §77b(11) (1976), defines "issuer" as including, *inter alia*, "any person directly or indirectly controlling . . . the issuer." Appellant concedes that the Dorfmans were controlling persons of LAM for purposes of the 1933 Act.

7] The SEC recently has promulgated an amendment to Rule 144 which permits a person selling securities under the rule to deal directly with a market maker in lieu of engaging a broker. Securities Act Release No. 5979, reprinted in [Current] Fed. Sec. L. Rep. (CCH) ¶81,731 (Sept. 19, 1978). Previously, a seller was forbidden from dealing directly with a market maker since the latter is continuously soliciting orders for shares. The Commission, however, now views the rule's requirements as "more stringent than necessary", *id.* at 80,930, and has revised the rule specifically to permit a seller to deal with a market maker.

The amendment, however, does not alter in any way our holding in the instant case. Aside from the fact that the amended rule was not in effect at the time of the instant transaction, the Commission explicitly has noted, "[t]he prohibitions against the solicitation of buy orders . . . have not been changed and therefore will continue to apply." *Id.* at 80,931. Thus, had the Dorfmans approached Aaron & Co. about a possible sale of LAM stock, the amended rule would have permitted Aaron & Co. to buy from the Dorfmans. However, the amended rule still would have prohibited Aaron & Co.'s actions in soliciting the Dorfmans to sell and in soliciting other customers buy orders in anticipation of the purchase of the Dorman's shares.

8] The Court defined scienter as "intent to deceive, manipulate, or defraud," 425 U.S. at 193 (footnote omitted). Various commentators nevertheless have debated what the Court meant by that definition. *See, e.g.,* Bucklo, The Supreme Court Attempts to Define Scienter Under Rule 10b-5: *Ernst & Ernst v. Hochfelder,* 29 Stan. L. Rev. 213 (1977); Haimoff, Holmes Looks at *Hochfelder* and 10b-5, 32 Bus. Law. 147 (1976); The Supreme Court, 1975 Term, 90 Harv. L. Rev. 56, 259 & nn.47 and 48 (1976); Note, Recklessness Under Section 10(b);

Weathering the *Hochfelder* Storm, 8 Rutgers-Camden L.J. 325, 342-51 (1977). Since we hold that scienter is not a requisite element of a government injunction action, we need not determine in this context what constitutes scienter within the Supreme Court's definition in *Hochfelder.*

9] The district court stated:

> "While negligence alone may suffice as a standard for liability in Commission enforcement proceedings, . . . the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws." *SEC v. E. L. Aaron & Co., supra,* [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,043 at 91,685.

10] *Compare* those cases which have held that scienter is required, *e.g., SEC v. Blatt,* 583 F.2d 1325 (5 Cir. 1978); *SEC v. Willis,* ——F. Supp. ——(D.D.C. 1978), 47 U.S.L.W. 2423 (U.S. Jan. 9, 1979); *SEC v. Cenco, Inc.,* 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC v. Bausch & Lomb, Inc.,* 420 F. Supp. 1226, 1241 (S.D.N.Y.), *aff'd on different grounds,* 565 F.2d 8 (2 Cir. 1977) (not reaching scienter issue) *with* those cases which suggest negligence will suffice, *e.g., SEC v. Arthur Young & Co.,* No. 77-1768 at 3 (9 Cir. Feb. 1, 1979); *SEC v. World Radio Mission,* 544 F.2d 535, 541 n.10 (1 Cir. 1976); *SEC v. Geotek,* 426 F. Supp. 715, 726 (N.D. Cal. 1976). Still other courts have discussed the question but have found it unnecessary to rule squarely on the issue. *E.g., SEC v. Savoy Industries, Inc.,* 587 F.2d 1149 (D.C. Cir. 1978); *SEC v. American Realty Trust,* 586 F.2d 1001 (4 Cir. 1978). *But cf., Edward J. Mawod & Co. v.*

SEC, No. 77-1495 at 16-18 (10 Cir. Jan. 24, 1979) (scienter required for SEC order suspending and revoking broker-dealer registration).

11] Berner & Franklin, Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of *Hochfelder*, 51 N.Y.U.L. Rev. 769 (1976); Haimoff, *supra*, 32 Bus. Law. at 166; Harkleroad, Requirements for Injunctive Actions Under The Federal Securities Laws, 2 Journal of Corp. Law 481 (1977); Note, The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After *Ernst & Ernst v. Hochfelder*, 77 Colum. L. Rev. 419 (1977); Note, Scienter and Injunctive Relief Under Rule 10b-5, 11 Ga. L. Rev. 879 (1977); Comment, Scienter and SEC Injunctive Suits, 90 Harv. L. Rev. 1018 (1977); Note, SEC Enforcement Actions to Enjoin Violations of Section 10(b) and Rule 10b-5: The Scienter Question, 5 Hofstra L. Rev. 831 (1977); Note, Scienter's Scope and Application In Light of *Hochfelder*, 52 Notre Dame Law. 925 (1977).

12] *SEC v. Coven*, 581 F.2d 1020, 1026 n.10 (2 Cir. 1978), *cert. denied*, ____ U.S. ____ (1979), 47 U.S.L.W. 3586 (U.S. March 5, 1979); *SEC v. Commonwealth Securities, Inc.*, 574 F.2d 90, 102 (2 Cir. 1978); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180-181 n.6 (2 Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978); *SEC v. Universal Major Industries*, 546 F.2d 1044, 1047 (2 Cir. 1977).

13] The Court noted that Congress, in structuring express civil remedies under the securities acts, clearly specified whether recovery was to be premised on negligence or knowing and intentional conduct. 425 U.S. at 207. To permit recovery of damages under §10(b) for negligent conduct would "nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." *Id.* at 210.

14] Indeed, an examination of the development of SEC injunction provisions in Congress, beginning with the precursor of both §17 and §20 of the final 1933 Act, 15 U.S.C. §77q and §77t (1970), demonstrates congressional rejection of a scienter requirement. The Senate draft of the 1933 provision required a showing of scienter for equitable relief:

> "It shall be unlawful for any person, firm, corporation, or other entity, directly or indirectly, in any interstate sale, promotion, negotiation, advertisement, or distribution of any securities *willfully* to employ any device, scheme, or artifice or to employ any 'dummy', or to act as any such 'dummy', with the intent to defraud or to obtain money or property by means of any false pretense, representation, or promise, or to engage in any transaction, practice or course of business relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser." Section 13 S.875, 73d Cong., 1st Sess., 77 Cong. Rec. 2982 (1933) (emphasis added).

However, the compromise drafted by the Conference Committee and adopted by both the House and the Senate ultimately rejected the Senate proposal and excluded mention of specific fraudulent intent altogether. H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933).

In connection with the creation of the SEC in 1934, the legislative history indicated that Congress was vitally concerned with the need to maintain the flexibility necessary for effective enforcement. *See, e.g.*, S. Rep. No. 792, 73d Cong., 2d Sess. 5 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 7 (1934). By

incorporating in the 1934 Act the same pattern of culpability requirements established by the 1933 Act, *see*, Section 210 of Title II of the 1934 Act, ch. 404, §210, 48 Stat. 881 (1934). Congress clearly indicated its rejection of a scienter standard for injunctive relief. This was made particularly clear by Congress' express rejection of an amendment proposed to limit injunctive relief under the 1933 Act through the establishment of a scienter standard. 78 Cong. Rec. 8703 (1934). See generally, Note, 77 Colum. L. Rev., *supra* note 11, at 429-35.

15] See note 14, *supra*.

16] Having ruled as we have on this question, we agree with the characteristically perceptive observation of our colleague, Judge Friendly, that the question is one "on which the final word will not rest with us." *SEC v. Commonwealth Securities, Inc., supra*, 574 F.2d at 101.

17] *Compare SEC v. American Realty Trust Co.*, 586 F.2d 1001 (4 Cir. 1978); *SEC v. World Radio Mission*, 544 F.2d 535, 541 n. 10 (1 Cir. 1976); *SEC v. Shiell*, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,190 (N.D. Fla. 1977); *SEC v. Southwest Coal & Energy Co.*, 439 F. Supp. 820, 826 (W.D. La. 1977); *SEC v. Geoteck*, 426 F. Supp. 715, 726 (N.D. Cal. 1976) (scienter not required under §17(a)) *with Sanders v. John Nuveen & Co.*, 544 F.2d 790 (7 Cir. 1977), *and SEC v. Cenco, Inc.*, 436 F. Supp. 193, 199-200 (N.D. Ill. 1977) (scienter required under §17(a)).

18] We note Judge Friendly's cogent observations regarding the evolving judicial attitude toward the issuance of injunctions on the basis of past violations. *SEC v. Commonwealth Chemical Securities, Inc., supra*, 574 F.2d at 99-100. In our view, Judge Friendly's observations would be particularly helpful in

reviewing the district court's exercise of discretion in a close case. But the instant case most assuredly is not a close one. As with the principal defendants in *Commonwealth* with respect to whom Judge Friendly had "no difficulty in sustaining the injunction", *id.* at 100, we hold likewise with respect to Judge Gagliardi's exercise of discretion in enjoining Aaron from future violations of the securities laws.

OPINION OF UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF NEW YORK

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

-against-

E.L. AARON & CO., INC., LAWN-A-MAT CHEMICAL & EQUIPMENT CORP. EDWARD L. AARON, PETER E. AARON, NORMAN LAWRENCE SCHREIBER, DONALD DARWIN JACOBSON, DANIEL DORFMAN, FERNANDO ERAZO,

Defendants.

76 Civ. 907

APPEARANCES:

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Opinion of United States District Court, Southern District of New York

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GAGLIARDI, D.J.

The complaint in this action filed on February 26, 1976 by plaintiff Securities and Exchange Commission ("Commission") charged eight defendants with violating and aiding and abetting violations of the anti-fraud provisions of the Securities Act of 1933 ("Securities Act"), Section 17(a), 15 U.S.C. §77q(a),[1] and the Securities Exchange Act of 1934 ("Exchange Act"), Section 10(b), 15 U.S.C. §78j(b)[2], and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5[3], in connection with the offer and sale of the common stock of Lawn-A-Mat Chemical & Equipment Corp. ("LAM"). Four of these defendants, including Peter Aaron, were also charged with violating and aiding and abetting violations of the registration provisions of the Securities Act, Sections 5(a) and 5(c), 15 U.S.C. §§77e(a)[4] and 77e(c)[5], in connection with the offer and sale of LAM stock. Thereafter, all of the defendants in this action except Peter Aaron consented to the entry of final judgments of permanent injunction.

The court conducted a three day evidentiary hearing on the Commission's motion for entry of a preliminary injunction and final judgment of permanent injunction[6] enjoining Peter Aaron from violating the registration and anti-fraud provisions of the securities laws. For the reasons set forth below, the court finds that Peter Aaron has violated both the registration and anti-fraud provisions and grants the Commission's motion for a preliminary and permanent injunction.

The Commission brings this action pursuant to section 21(b) of the Securities Act, 15 U.S.C. §77t(b), and section 21(d) of the Exchange Act, 15 U.S.C. §78u(d) to enjoin these alleged violations. This court has jurisdiction of this action pursuant to Section 22(a) of the Securities Act, 15 U.S.C. §77v(a), and Section 27 of the Exchange Act, 15 U.S.C. §78aa. The defendant has engaged in certain acts and practices within the Southern District of New York constituting, in part, the violations of the securities laws alleged. Such actions were effected by making use of the means and instrumentalities of interstate commerce and of the mails.

The court having considered the pleadings, the testimony of witnesses and the documents in evidence makes the following findings of fact and conclusions of law as required by Rule 52 Fed. R. Civ. P.

Findings of Fact

1. E.L. Aaron & Co., Inc. ("Aaron & Co.") was a New York corporation with its principal offices located in New York, New York. During the period from November 1974 through September 1975 ("the relevant period") Aaron & Co. also operated a branch office in Roslyn Heights, New York. During the relevant period Aaron & Co. was a broker-dealer registered with the Commission and a member of the National Association of Securities Dealers, Inc. ("NASD"). During the relevant period Aaron & Co. had as many as 50 employees including 25 full-time and 15 part-time registered representatives. Aaron & Co. is no longer doing business.

2. Edward Aaron was the president, sole officer and sole stockholder of Aaron & Co. He spent almost all of the business day in the trading room executing orders and trading securities.

3. Defendant Peter Aaron is the son of Edward Aaron. He was employed at Aaron & Co. for a period of 15 years. During the relevant period he was a registered representative, assistant to the president; and the liason between the operations department, the registered representatives and the trading room. He also maintained due diligence files for the securities in which Aaron & Co. made markets. He was not registered with the NASD as a principal of Aaron & Co.

4. Peter Aaron performed additional duties at Aaron & Co. He conducted sales meetings with registered representatives at which sales techniques were discussed, and monitored the trading of representatives advising them of their monthly production figures, informing them of their clients who were late in payment, and ensuring that the representatives did not exceed their individual selling capacities. He also participated with his father in the hiring of Aaron & Co. employees and performed other duties.

5. In sum, Peter Aaron, along with his father, had supervisory responsibility over Aaron & Co.'s registered representatives and other employees. He and his father only were authorized to sign checks at Aaron & Co. Peter Aaron received a salary, bonuses, expenses and other payments from Aaron & Co. at a level comparable to Edward Aaron. He expected to inherit complete ownership of Aaron & Co. from his father. In sum, Peter Aaron functioned in a managerial and supervisory capacity over all the activities at Aaron & Co. In particular, he supervised the registered representatives and received and answered complaints about their activities.

6. Norman Schreiber ("Schreiber") at all times relevant was associated with Aaron & Co. as a registered representative and was branch manager of Aaron & Co.'s Roslyn Heights office.

7. Donald Jacobson ("Jacobson") at all times relevant was associated with Aaron & Co. as a registered representative working in the Roslyn Heights office.

8. LAM is a New York corporation engaged in the business of selling franchises and products for lawn care and provides combines, trailers and tractors to franchisees for the application of lawn care products, which are also supplied by LAM. At all times relevant the common stock of LAM was registered with the Commission pursuant to Section 12(g) of the Exchange Act, 15 U.S.C. 781(g), and was traded in the over-the-counter market. LAM filed all required forms with the Commission, such forms and other reports of LAM were maintained in the files of Aaron & Co.

9. Daniel Dorfman at all times relevant was a director and major stockholder of LAM. From October, 1974 through November, 1975 Daniel Dorfman was not involved with the day-to-day operations of LAM.

10. Fernando Erazo ("Erazo"), during all times relevant was a director, chief operating officer and, at various times, president and executive vice president of LAM.

Violations of the Anti-Fraud Provisions

A. False and Misleading Representations

11. During the relevant period Aaron & Co. made a market in the common stock of LAM. LAM furnished to Schreiber and Jacobson copies of its stockholders' list and franchise-dealers' list. Schreiber and Jacobson contacted persons on these lists by phone and by use of the mails to solicit orders for LAM stock.

12. Some of the persons contacted complained or inquired of LAM officers and employees regarding the representations

made by Schreiber or Jacobson. Erazo and Milton Kean ("Kean"), attorney for LAM, subsequently requested Schreiber and Jacobson to halt making false and misleading statements in connection with these solicitations.

13. Some of the false or misleading information that Schreiber or Jacobson told prospective purchasers of LAM included the representation that LAM was planning or in the process of manufacturing a new type of small car and a tractor. Investors contacted were told among other things that the car would be manufactured in a venture with a Japanese outfit and the new car would be coming out in six weeks. LAM, however, was not manufacturing a car or tractors and did not plan to do so.[7] Furthermore, both Erazo and Kean informed Schreiber and Jacobson that their statements were false.

14. Schreiber and Jacobson also supplied prospective investors false or misleading information concerning the financial condition of LAM and projected substantial increases in the price of the stock. Their projections of the increasing sales and earnings of LAM had no basis in fact as LAM continued losing money during the relevant period.

B. Peter Aaron's Knowledge and Failure to Act

15. Kean spoke to Peter Aaron by telephone on two occasions during the relevant period, the first in April 1975 and the second subsequent, to inform him that Schreiber and Jacobson were making false and misleading statements in connection with their campaign of selling LAM stock. Specifically, Kean informed Peter Aaron that Schreiber and Jacobson, without any basis in fact, were informing prospective purchasers of LAM stock that LAM was planning or already

manufacturing a car and a tractor. Kean also informed Peter Aaron that Schreiber and Jacobson were making misrepresentations about the financial condition of LAM.

16. Peter Aaron, in addition to being informed by Kean, had reason to know that the statements by Schreiber and Jacobson were false or misleading. As the individual at Aaron & Co. responsible for maintaining the due diligence files which included LAM's files, Peter Aaron was aware that LAM by its reports did not indicate that it was building or planning a car or a tractor and did indicate a deteriorating financial condition.

17. After Kean made these objections to him, Peter Aaron notified Jacobson of Kean's complaint but did nothing to correct or stop the false and misleading misrepresentations which Schreiber and Jacobson then continued to make.

Violations of the Registration Provisions

18. During the relevant period representatives of Aaron & Co., through use of the telephone and the mails, continuously solicited customers for the purchase of LAM common stock. Peter Aaron knew of this solicitation.

19. During the relevant period representatives of Aaron & Co. solicited the sale of 1,000 shares of LAM common stock from Daniel Dorfman and 20,000 shares of LAM common stock from Fred Dorfman, a Vice President and Director of LAM. This LAM stock which was unregistered was sold pursuant to the exemption from the registration provisions of the Securities Act provided by Rule 144, 17 C.F.R. 230.144.

20. At about the same time Aaron & Co. arranged with J.W. Weller & Co., Inc. ("Weller & Co."), a New Jersey broker-dealer, for Weller & Co. to act as an intermediary in

transactions in which Aaron & Co. would purchase LAM stock from its own customers. Peter Aaron participated in those transactions by making the initial contact with Weller & Co. and it was with his approval that the Dorfman transactions were effected. Aaron & Co. arranged the sale of the Dorfman's stock to Weller & Co. and then purchased the same shares from Weller & Co. In each case representatives of Aaron & Co. told the Dorfmans to send their stock to Weller & Co., neither of them previously having done business with nor heard of Weller & Co. In each case Aaron & Co. purchased for its own account the Dorfman's stock through Weller & Co. In the case of Fred Dorfman's stock, Aaron & Co. purchased it in three blocks of 5,000, 5,000 and 10,000 shares from Weller & Co.

21. In sum and effect the Dorfmans sold their stock directly to Aaron & Co. Weller & Co. was a mere intermediary directed by Aaron & Co. for the purposes of these transactions.

22. In each case Aaron & Co. purchased the Dorfman's stock for its principal account. These shares were then sold at a later date to the public from its principal account. In so doing Aaron & Co. was acting as a principal or dealer for its own account and not as an agent or broker for a customer.

23. Counsel for Aaron & Co. never advised Peter Aaron or anyone at Aaron & Co. that the arrangement with Weller & Co. to act as a prearranged intermediary in the sale of the Dorfman's stock was in compliance with §5(a) and (c) of the Securities Act.

Conclusions of Law

Violations of the Anti-Fraud Provisions

Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, as

judicially construed and applied, mandate fair dealing in connection with the offer or sale of any securities. *See SEC v. Capital Gains Research,* 375 U.S. 180, 201 (1963); *SEC v. Galaxy Foods, Inc.,* 417 F. Supp. 1225, 1244 (E.D.N.Y. 1976).

In this case Aaron & Co., through its registered representatives Schreiber and Jacobson, was continuously during the relevant period soliciting sales of LAM stock. In connection with the solicitation, Schreiber and Jacobson knowingly made false and misleading statements to prospective customers concerning LAM's activity in manufacturing a car and a tractor and concerning LAM's financial condition. Although employees of LAM and their counsel informed Schreiber and Jacobson that their representations were false, and the LAM reports on file at Aaron & Co. indicated that these representations had no basis in fact, Schreiber and Jacobson continued to make them. In sum, Jacobson and Schreiber knowingly and intentionally made false and misleading statements in connection with the offer and sale of the common shares of LAM, clear violations of the anti-fraud provisions of the securities laws. *See, e.g., SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833 (2d Cir. 1968) (*en banc*), *cert. denied,* 394 U.S. 976 (1969); *Hanly v. SEC,* 415 F.2d 589 (2d Cir. 1969); *SEC v. Cooper,* 402 F. Supp. 516 (S.D.N.Y. 1975).

Peter Aaron knew of the activities of Schreiber and Jacobson. He was called twice by Milton Kean, counsel for LAM, and told that Schreiber and Jacobson were giving prospective customers false information about LAM's manufacture of a car and a tractor and false information on the financial condition of LAM. Kean had previously called Schreiber and Jacobson directly and told them without effect to cease their activity. Peter Aaron had reason to know, independent of Kean's notification, that what Schreiber and Jacobson were representing was false and misleading. As the

individual responsible for the due diligence files, which included up-to-date reports on LAM, Peter Aaron had all of the current information on LAM, none of which indicated the company's activities or projected growth that Schreiber and Jacobson were reporting. Peter Aaron stated to Kean that he would stop the misrepresentations. However, he did nothing to stop the activity and only contacted Jacobson and told him to contact Kean.

Peter Aaron had a managerial and supervisory position at Aaron & Co. While he was neither registered as a principal with the NASD, nor denominated as an officer of Aaron & Co., based upon his involvement with the affairs of the firm, his participation in management decisions, his compensation and his close association with his father, he functioned in a managerial capacity at Aaron & Co. *Cf. SEC v. E.J. Albanese Co. Inc.,* CCH Fed. Sec. L. Rep. ¶95,778 (S.D.N.Y. 1976). In such capacity he was specifically responsible for supervising the registered representatives. In fact, when Kean called Aaron & Co. to complain about Schreiber and Jacobson, he was first connected with Edward Aaron who told him that such complaints should be made to Peter Aaron.

Consequently, Peter Aaron, although never an officer, director or shareholder of Aaron & Co., by virtue of his active participation in the management of the firm and his knowledge both of the firm's solicitation of LAM stock and the false and misleading statements being made by Schreiber and Jacobson in connection with that solicitation, must be held responsible along with Schreiber and Jacobson for the fraudulent representations that were made. *See Gross v. SEC,* 418 F.2d 103, 106 (2d Cir. 1969); *SEC v. Galaxy Foods, Inc., supra,* 417 F. Supp. at 1246-47. While Peter Aaron himself did not make any misrepresentations, by failing to stop Schreiber and Jacobson, he wilfully aided and abetted their violations of the anti-fraud

provisions of the securities laws.[8] *See Gross v. SEC, supra; SEC v. Galaxy Foods, Inc., supra; SEC v. E.J. Albanese & Co., Inc., supra; SEC v. Charles A. Morris & Assoc., Inc.,* CCH Sec. L. Rep. ¶93,756 at 93,306 (W.D. Tenn. 1973); *see also SEC v. Barraco,* 438 F.2d 97 (10th Cir. 1971).

While negligence alone may suffice as a standard for liability in Commission enforcement proceedings, *SEC v. Universal Major Industries Corp.,* 546 F.2d 1044 (2d Cir. 1976); *SEC v. World Radio Mission, Inc.,* CCH Fed. Sec. L. Rep. ¶95,751 (1st Cir. 1976); *contra SEC v. Bauch & Lomb, Inc.,* CCH Fed. Sec. L. Rep. ¶95,722 (S.D.N.Y. 1976), appeal docketed, No. 73 Civ. 2458 (2d Cir. Sept. 16, 1976), the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws. *See SEC v. Universal Major Industries, supra* at 1046-47; *SEC v. Galaxy Foods, Inc., supra,* 417 F. Supp. at 1245-46. Therefore, Peter Aaron's conduct under either a negligence or a scienter theory of liability violated and aided and abetted violations of the anti-fraud provisions of the securities laws.

Violations of the Registration Provisions

Section 5 of the Securities Act prohibits the sale of a security by any person unless a registration statement is in effect as to that security or unless there is an exemption from the requirements of the section. In this case 21,000 shares of LAM stock sold by Daniel and Fred Dorfman, officers and directors of LAM, were without registration. Violations of §5(a) and (c) thus follow automatically, unless some exemption from registration is available.

The burden of establishing the availability of an exemption from the requirements of Section 5 is on Peter Aaron, the one claiming the exemption. *SEC v. Ralston Purina Co.,* 346 U.S. 119, 126 (1953); *SEC v. Culpepper,* 270 F.2d 241, 246 (2d Cir. 1959); *SEC v. Galaxy Foods, Inc., supra,* 417 F. Supp. at 1242.

Defendant relies on the exemption provided in Rule 144, 17 C.F.R. 230.144, which, in conjunction with §§4 and 2(11) of the Securities Act, 15 U.S.C. §77d and 77(b)(11), permits the public sale of certain unregistered securities, like the 21,000 shares sold by the Dorfmans, if the sale is made in accordance with *all* the conditions of the Rule. In this case it is undisputed that the only provisions of Rule 144 possibly not complied with were 144(f) and (g).

Rule 144(f) provides:

> (f) Manner of Sale. The securities shall be sold in "brokers' transactions" within the meaning of Section 4(4) of the Act and the person selling the securities shall not (i) solicit or arrange for the solicitation of orders to buy the securities in anticipation of or in connection with such transactions or (ii) make any payment in connection with the offering or sale of the securities to any person other than the broker who executes the order to sell the securities.

Rule 144(g) provides:

> (g) Brokers' Transactions. The term "brokers' transactions" in Section 4(4) of the Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker —

> (1) does no more than execute the order or orders to sell the securities as agent for the person for whose account the securities are sold; and receives no more than the usual and customary broker's commission;
>
> (2) neither solicits nor arranges for the solicitation of customers' orders to buy the securities in anticipation of or in connection with the transaction; provided, [certain exceptions not relevant here] . . . .

Aaron & Co., through transactions in LAM stock arranged and approved by Peter Aaron, did not comply with Rule 144(f) and (g) for two reasons. First, Aaron & Co., in arranging for the Dorfmans' sale of LAM stock, acted as a principal for its own account and never as a mere agent for the seller. Employees of Aaron & Co. solicited the Dorfmans' sales and, as a market-maker for LAM stock, purchased the stock for its own account. Accordingly, the sales were not "brokers' transactions" because Aaron & Co. was not acting "as agent" for the Rule 144 sellers as required by Rule 144(f) and (g)(1). Second, Aaron & Co. was soliciting customers' orders to buy LAM securities in connection with the Dorfmans' sales in violation of Rule 144(g)(2).

Aaron & Co. and Peter Aaron cannot avoid these requirements of Rule 144 by arranging for the sales of the Dorfmans' stock through an intermediary. Weller & Co.'s participation in the transaction was a sham to evade the intent of the Rule while feigning technical compliance.[9] If Aaron & Co. had purchased the Dorfmans' stock from Weller & Co. or another broker-dealer in an open market interdealer transaction,

Aaron & Co. would not have violated Rule 144. In this case, however, Weller & Co. was not acting "as agents" for the Dorfmans but only as an intermediary-agent for Aaron & Co. who arranged the whole transaction.

Aaron & Co. solicited the sale and arranged the price. Neither Daniel nor Fred Dorfman ever heard of or dealt with Weller & Co. and each was first told by agents of Aaron & Co. that their sale would be through Weller & Co. Aaron & Co. effectively purchased the stock directly from the Dorfmans. This conduct was not in compliance with Rule 144 and as a result defendant has not met his burden of establishing an exemption to Section 5 of the Securities Act. Therefore, defendant in concert with others at Aaron & Co. directly and indirectly violated and aided and abetted violations of §5(a) and (c) of the Securities Act.[10]

Defendant contends, as a defense, relying on *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191-92 n. 7 (1976), that if liability may be found to exist it must be based on scienter rather than negligence. However, *Hochfelder* only passed upon a private suit for damages in a §10(b) context and not upon Commission injunctive actions under §5. The law of this circuit is that negligence, and not scienter, is all that is required in a Commission injunction proceeding under §5. *SEC v. Universal Major Industries, supra,* 546 F.2d at 1046-47. However, even if scienter were required, defendants acted with knowledge or reckless disregard of the illegality of the arrangement with the Dorfmans and Weller & Co. This is sufficient to establish scienter. *SEC v. Universal Major Industries Corp., supra,* at 1047; *citing, Lanza v. Drexel & Co.,* 479 F.2d 1277 (2d Cir. 1973).

Defendant's last defense, that he relied upon the advice of counsel in arranging the Rule 144 transactions, is without basis in the evidence. While good faith reliance on advice of counsel may be a factor to consider in deciding whether to grant injunctive relief, *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1101, *SEC v. Senex Corp.,* 399 F. Supp. 497, 507 (E.D. Kty. 1975), in this case there was no reliance because defendant did not follow the opinion of his counsel. *SEC v. Senex Corp., supra; United States v. Hill,* 298 F. Supp. 1221, 1235 (D. Conn. 1969).

Counsel for Aaron & Co. only advised that in the sale of Rule 144 stock the seller be referred to several other brokers, and that Aaron & Co. could then buy those shares in an open market transaction. Counsel specifically stated that he never advised Peter Aaron or anyone at Aaron & Co. to have Aaron & Co. arrange for Rule 144 stock to be sold to another broker-dealer with whom Aaron & Co. already had an arrangement to purchase the stock for subsequent sale to its own customers. Peter Aaron, having not followed the advice of counsel, cannot rely on this defense to his violation of §5(a) and (c) of the Securities Act.

Injunctive Relief

The standard governing the issuance of injunctive relief in a Commission enforcement action is whether there is a reasonable likelihood that the violations will be repeated. *SEC v. Culpepper,* 270 F.2d 241, 249-50 (2d Cir. 1959), *SEC v. Scott, Gorman Municipals, Inc.,* 407 F. Supp. 1383, 1387 (S.D.N.Y. 1975); *SEC v. Raga,* CCH Fed. Sec. L. Rep. ¶95,222 (S.D.N.Y. 1974).

In this case, Peter Aaron while not presently in the securities business clearly expressed at trial a strong interest in

returning to the securities industry. He is currently working in the related field of commodities trading. Under the circumstances, in this court's view, this indicates a likelihood of Peter Aaron's further violations of these securities laws in the future. In light of the nature and extent of the violations of the anti-fraud and registration provisions, the defendant's failure to recognize the wrongful nature of his conduct and the likelihood of the defendant repeating his violative conduct, the court is convinced that the public interest requires issuance of the Commission's requested preliminary and permanent injunctions. *See SEC v. Universal Major Industries Corp., supra,* 546 F.2d at 1048; *SEC v. Management Dynamics, Inc., supra,* 515 F.2d at 807; *SEC v. Manor Nursing Centers, Inc., supra,* 458 F.2d at 1100-02.

Submit judgment on five days' notice.

U.S.D.J.

Dated: New York, New York
May 3, 1977.

FOOTNOTES

1. Section 17(a) provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

2. Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. Rule 10b-5 provides:

> Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or

> would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. Section 5(a) provides:

> Unless a registration statement is in effect as to security, it shall be unlawful for any person, directly or indirectly —
>
> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

5. Section 5(c) provides:

> It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior

> to the effective date of the registration statement) any public proceeding or examination under section 8.

6. Pursuant to Rule 65(a)(2) Fed. R. Civ. P., the Commission moved at the commencement of the hearing, with the consent of the defendant, for consolidation of their motions for preliminary and permanent injunctions.

7. Only Daniel Dorfman, speaking on his own behalf and not for LAM, ever even mentioned a prospective plan that he and not LAM intended to build a car, and he never spoke in the concrete terms described by Schreiber and Jacobson.

8. Defendant's claim that his liability should be measured solely by the "control person" standard of §20(a) of the Exchange Act is without merit. In Commission enforcement actions, §20(a) was not intended as the sole measure of employer liability. *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975). Section 20(a) has not preempted or restricted operation of general rules in the securities field. *Fey v. Walston & Co., Inc.*, 493 F.2d 1036, 1052 (7th Cir. 1974).

9. The Commission recognized the illegality of such technical compliance in Securities Act Release No. 5223, CCH Fed. Se. L. Rep. ¶ 78,487 at 81,061 (January 11, 1972), announcing the official adoption of Rule 144 and interpreting its provisions:

> In view of the objectives and policies underlying the Act [Securities Act of 1933], the rule shall not be available to any individual or entity with respect to any transaction which, although in technical compliance with the provisions of the

> rule, is part of a plan by such individual or entity to distribute or redistribute securities to the public. In such case, registration is required.

10. This holding is consistent with the Commission's position in its staff interpretative letters clarifying the meaning and application of Rule 144. *Carolina Securities Corp.*, CCH Fed. Sec. L. Rep. ¶80,803 (Oct. 7, 1976) and ¶80,853 (Dec. 8, 1976); *Herzog & Co., Inc.*, CCH Fed. Sec. L. Rep. ¶79,801 (May 15, 1974); *Ag-Met Inc.*, CCH Fed. Sec. L. Rep. ¶79,796 (May 2, 1974).

Supreme Court, U.S.
FILED
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MICHAEL RODAK, JR., CLERK

APPENDIX

In The

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-66

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED JULY 9, 1979
CERTIORARI GRANTED OCTOBER 15, 1979

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The following opinions have been omitted in printing this appendix because they appear on the following pages in the appendix to the printed Petition for Certiorari:

Opinion of the District Court for the Southern District of New York, dated May 3, 1977 ..... A30

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CHRONOLOGICAL LIST OF RELEVANT DOCKET ENTRIES

76-0907 Judge Gagliardi

S.E.C. -vs- E.L. Aaron & Co. Inc., et al.

DATE	PROCEEDINGS
2-26-76	Filed complaint and issued summons.
2-26-76	Filed Pltffs Affdvt and Order for appt to make service upon defts. pursuant to Rule 4(c) FRCP of Summons and Complaint by Tucker, Mandel, Globerman, Valery, Catalano, Lindsay, etc. Clk.
3-9-76	Filed Pltff's affdvt and Notice of Motion re: order of preliminary injunction enjoining Defts. E.L. Aaron & Co. Inc., Edward L. Aaron, Peter E. Aaron and Norman Lawrence Schreiber from further violations of Sec. Act of 1933, etc. ret. 3/16/76.
3-9-76	Filed Affdvt of Service by Thomas E. Valery for pltff pf copies of Notice of Motion for Preliminary Injunction and Affdvt and Memorandum of Law in support of defts. Lawn-A-Mat Chemical & Equipment Corp and Daniel Dorfman by Daniel Dorfman on 3/1/76.
3-9-76	Filed Affdvt of Service by Remo Catalano for pltff on 2/26/76 of copies of Notice of Motion for Preliminary Injunction, Affidavit and Memorandum of Law in support on defts. E.L. Aaron & Co. Inc., Edward L. Aaron, Peter E. Aaron, Norman Lawrence Schreiber and Donald Darwin Jacobson, by Martin Kaplan, US

Relevant Docket Entries

	Courthouse; also service on Fernando Erazo by personally handing such documents to same personally on 2/26/76.
3-9-76	Filed Memorandum of Law in support of pltff's motion for preliminary injunction.
3-15-76	Filed ANSWER of Deft. E.L. Aaron & Co. Inc. BLG
3-15-76	Filed ANSWER of Deft. Norman Lawrence Schreiber BLG
3-15-76	Filed ANSWER of Deft. Donald Darwin Jacobson BLG
3-15-76	Filed ANSWER of Deft. Peter E. Aaron BLG
3-15-76	Filed ANSWER of Deft. Edward L. Aaron BLG
3-31-76	Filed Judgment of Permanent Injunction of Fernando Erazo by Consent. Ordered that deft. Erazo, etc. are permanently enjoined from directly or indirectly employ any device, scheme or artifice to defraud, etc. Further ordered that deft. Erazo make himself available and respond to any subpoena or notice to take deposition at request by SEC. Gagliardi, J. JUDGMENT ENTERED. Clk
4-13-76	Filed Summons with Affdvt of Service by Remo Catalano for pltff upon all defts (except Laun-A-Mat Chemical & Equipment Corp and Daniel Dorfman) on 2/26/76 and Fernando Erazo same date, 3 p.m.

Relevant Docket Entries

	Affdvt of Service by Thomas E. Valery for pltff upon defts. Lawn-A-Mat Chemical & Equipment Corp and Daniel Dorfman on 3/1/76, 5:10 p.m. approximately.
5-4-76	Filed Affdvt of Acknowledgement by Fernando Erazo, deft of certified copy of Final Judgment of Permanent Injunction against same.
5-24-76	Filed Final Judgment of Permanent Injunction of Deft. Daniel Dorfman by consent. Gagliardi, J. JUDGMENT ENTERED. Ent. 5/25/76
5-28-76	Filed Final Judgment of Permanent Injunction of Deft. E.L. Aaron & Co. Inc. by Consent. Gagliardi, J. JUDGMENT ENTERED. Clk. Ent. 6/1/76
5-28-76	Filed Final Judgment of Permanent Injunction of Deft. Edward L. Aaron by Consent. Gagliardi, J. JUDGMENT ENTERED. Clk. Ent. 6/1/76
5-28-76	Filed Final Judgment of Permanent Injunction of Norman Lawrence Schreiber by Consent. Gagliardi, J. JUDGMENT ENTERED. Clk. Ent. 6/1/76
5-29-76	Filed Final Judgment of Permanent Injunction of Donald Darwin Jacobson by Consent. Gagliardi, J. JUDGMENT ENTERED. Clk. Ent. 6/1/76
6-28-76	Filed ANSWER of Deft. Peter E. Aaron. CJH
8-3-76	Filed Affdvt of Peter Aaron in opposition to pltff's Motion for Preliminary Injunction.

Relevant Docket Entries

8-19-76	Filed 1st set of interrogs propounded to pltff by deft. Peter Aaron.
8-26-76	Filed Affdvt of Acknowledgment by Edward L. Aaron for pltff with certified copy of Final Judgment of Permanent Injunction, signed 5/28/76.
8-26-76	Filed Affdvt of Acknowledgment by Edward L. Aaron for pltff with certified copy of Final Judgment of Permanent Injunction against E.L. Aaron & Co. Inc. on 6/1/76.
8-26-76	Filed Affdvt of Acknowledgement by Donald Darwin Jacobson for Pltff of certified copy of Final Judgment of Permanent Injunction on 5/28/76.
8-26-76	Filed Affdvt of Acknowledgment by Norman Lawrence Schreiber of certified copy of Final Judgment of Permanent Injunction on May 28, 1976.
8-26-76	Filed Pltff's Notice to take deposition of Dan Brescher.
8-26-76	Filed Pltff's Notice to take deposition of Peter E. Aaron.
9-17-76	Filed pltff. Commission's Answers to deft. Peter E. Aaron's first set of interrogs.
9-21-76	Filed Defts. Notice of Deposition of Milton Kean Pursuant to Rules 26 and 30 of the F.R.C.P. at 3:00 P.M. on 10-4-76.

Relevant Docket Entries

9-28-76	Filed Affdvt of Acknowledgment by Daniel Dorfman of Copy of Final Judgment of Permanent Injunction on 6/10/76.
10-8-76	Filed Final Judgment of Permanent Injunction of Lawn-A-Mat Chemical & Equipment Corp. by Consent. Gagliardi, J. JUDGMENT ENTERED. Clk (mn) Ent. 10/8/76
10-19-76	Filed Deposition of Peter Aaron (mn)
10-19-76	Filed Deft. Peter Aaron notice to take deposition of Fernando Erazo.
11-1-76	Filed Pltff's notice to take deposition of Edward L. Aaron.
11-10-76	Filed Letter from SEC dated 11/9/76 to Charles Hecht, Esq. of withdrawal of notice to take deposition of Edward L. Aaron.
11-10-76	Filed Affdvt of Acknowledgment by Daniel Dorfman, deft of certified copy of Final Judgment of Permanent Injunction on 10/8/76.
12-9-76	Filed Pltff's Notice to Take Deposition of Silverman; Kaplan & Strauss.
12-13-76	Filed Pltff's Notice to Take Deposition of Philip Shapiro.
12-27-76	Filed Pltff's Notice of Deposition of Stanley Gordon on 12-18-76.
1-6-77	Filed Principal issues submitted on behalf of deft. Peter M. Aaron.

Relevant Docket Entries

1-6-77	Filed Proposed Findings of Fact and Conclusions of Law submitted on behalf of deft. Peter E. Aaron.
1-10-77	Filed Principal issues submitted on behalf of deft. Peter E. Aaron.
1-11-77	Trial begun with Non-Jury before Gagliardi, J.
1-12-77	Trial contd.
1-13-77	Trial contd.
1-14-77	Trial contd. and concluded. Decision reserved.
2-2-77	Filed Memorandum of Law of Deft. Peter Aaron.
2-4-77	Filed Pltff's Proposed Findings of Fact and Conclusions of Law.
2-4-77	Filed Pltff's Memorandum in Support of Proposed Findings of Fact and Conclusions of Law.
2-9-77	Filed Deft. Peter Aaron Reply Memorandum.
2-10-77	Filed Pltff's Reply Brief.
4-13-77	Transcript of record of proceedings dated 1-11, 12-13-14-77.
4-15-77	Filed Transcript of Record of Proceedings dated 1-11-77.
4-15-77	Filed Transcript of Record of Proceedings dated 1-12-77.

Relevant Docket Entries

4-15-77	Filed Transcript of Record of Proceedings dated 1-13-77.
4-15-77	Filed Transcript of Record of Proceedings dated 1-14-77.
4-15-77	Filed Summaries of Depositions of Donald Jacobson, Kaplan, Strauss, Gordon, Silberman, Firrinciello and Shapiro submitted by Deft. Peter Aaron.
4-15-77	Filed Proposed Findings of Fact and Conclusions of Law submitted on behalf of Deft. Peter E. Aaron.
4-15-77	Filed Deft. Peter E. Aaron Synopsis of principal cases and principal issues.
4-15-77	Filed Principal issues submitted on behalf of Deft. Peter E. Aaron.
5-5-77	Filed OPINION #45870. SUBMIT JUDGMENT ON 5 Day's Notice. Gagliardi, J. m/n
5-24-77	Filed Final Judgment of Permanent Injunction of Peter E. Aaron, Deft. Ordered that Deft. Peter E. Aaron, agents, etc. are permanently enjoined from directly or indirectly in absence of any applicable statutory exemption as indicated. Court shall retain jurisdiction of this matter for all purposes. Gagliardi, J. JUDGMENT ENTERED. Clk m/n Ent. 5/24/77
6-2-77	Filed Deft. Peter E. Aaron's Notice of Appeal from Final Judgment of Permanent Injunction entered on 5 24 77. (mailed copy to William D. Moran, Adm. 26 Federal Plaza, NY 10007)

Relevant Docket Entries

6-3-77	Filed Stip and Order of substitution of attys. for Peter E. Aaron.
6-8-77	Filed Affidavit of Service of a certified copy of the Final Judgment of Permanent Injunction by Jonathan O. Lee.

COMPLAINT OF THE SECURITIES AND EXCHANGE COMMISSION FILED FEBRUARY 26, 1976

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

SECURITIES AND EXCHANGE COMMISSION

Plaintiff,

-against-

E.L. AARON & CO., INC.
LAWN-A-MAT CHEMICAL & EQUIPMENT CORP.
EDWARD L. AARON
PETER E. AARON
NORMAN LAWRENCE SCHREIBER
DONALD DARWIN JACOBSON
DANIEL DORFMAN
FERNANDO ERAZO

Defendants.

76 Civil 907

Judge Gagliardi

Plaintiff, Securities and Exchange Commission ("Commission"), for its Complaint herein alleges:

1. Defendants E.L. Aaron & Co. Inc., Edward L. Aaron, Peter E. Aaron and Norman Lawrence Schreiber, have been engaged, are engaged and are about to engage in acts and practices which constitute and will constitute, violations of Sections 5(a) and 5(c) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77e(a) and 77e(c); and defendants E.L. Aaron & Co. Inc., Edward L. Aaron, Peter E. Aaron, Norman Lawrence Schreiber, Donald Darwin Jacobson, Lawn-A-Mat

Chemical & Equipment Corp., Daniel Dorfman and Fernando Erazo, have been engaged, are engaged, and are about to engage in acts and practices which constitute, and will constitute, violations of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a) and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

2. The Commission, pursuant to authority contained in Sections 10(b) and 23(a) of the Exchange Act, 15 U.S.C. 78j(b) and 78w(a), has promulgated Rule 10b-5, 17 C.F.R. 240.10b-5 thereunder, which is now and at all times herein relevant been in effect.

JURISDICTION AND VENUE

3. The Commission brings this action pursuant to authority conferred by Section 21(b) of the Securities Act, 15 U.S.C. 77t(b), and Section 21(d) of the Exchange Act, 15 U.S.C. 78u(d) to enjoin said acts and practices.

4. This Court has jurisdiction of this action pursuant to Section 22(a) of the Securities Act, 15 U.S.C. 77v(a), and Section 27 of the Exchange Act, 15 U.S.C. 78aa.

5. The defendants have been engaged and are engaged in certain acts and practices within the Southern District of New York and elsewhere in connection with, and constituting the violations complained of herein. Such actions were effected by making use of the means and instrumentalities of interstate commerce and of the mails.

THE DEFENDANTS

6. *Defendant E.L. Aaron & Co. Inc.* ("Aaron & Co."), is a New York corporation with its principal office located at 50

Broad Street, New York, New York 10004. In November 1974, Aaron & Co. opened a branch office at 142 Mineola Avenue, Roslyn Heights, New York ("Long Island Office"). Aaron & Co. is a broker-dealer registered with the plaintiff Commission since June 5, 1961 pursuant to the provisions of Section 15(b) of the Exchange Act, 15 U.S.C. 78o, and is a member of the National Association of Securities Dealers, Inc.

7. *Defendant Lawn-A-Mat Chemical & Equipment Corp.* ("LAM"), formerly known as Consolidated Home and Garden Services, Inc., is a New York corporation with its executive offices located at 153 Jefferson Avenue, Mineola, New York. LAM's common stock has been registered with the Commission pursuant to Section 12(g) of the Exchange Act, 15 U.S.C. 781(g), since March 1967 and is traded in the over-the-counter market. As of December 31, 1974, LAM had issued and outstanding 2,229,232 common shares owned by some 676 shareholders. LAM is engaged in the business of selling franchises and products for lawn care, and provides combines, trailers and tractors to franchisees for the application of lawn care products also supplied by LAM. On January 23, 1976 LAM filed a petition for an arrangement pursuant to Chapter XI of the Bankruptcy Act in the United States District Court for the Eastern District of New York.

8. *Defendant Edward L. Aaron* ("E. Aaron") is the president and sole shareholder of Aaron & Co. and had been a partner in the firm's predecessor from 1947 to its incorporation in 1961. E. Aaron resides at 3215 Netherland Avenue, Bronx, New York.

9. *Defendant Peter E. Aaron* ("P. Aaron"), the son of E. Aaron, is assistant to the president and, during the relevant period referred to herein, functioned as office manager of Aaron & Co. He has been associated with Aaron & Co. as a registered representative since 1967 and resides at 119 State Street, Brooklyn, New York.

10. *Defendant Norman Lawrence Schreiber* ("Schreiber") was associated with Aaron & Co. as a principal of the firm from October 1974 to September 1975. Schreiber resides at 191 North Elm Street, North Massapequa, New York.

11. *Defendant Donald Darwin Jacobson* ("Jacobson") was associated with Aaron & Co. as a registered representative in its Long Island Office from December 1974 to September 1975. Jacobson resides at 50 The Birches, Roslyn Estates, New York.

12. *Defendant Daniel Dorfman* ("Dorfman") was president, chief operating officer and chairman of the board of directors of LAM from its inception in 1961 to September 1974. From September 1974 to March 1975, he was chairman of the board of directors and president. From March 1975 to the present, Dorfman has been chairman of the board of directors and owns or controls over 43% of the common stock of LAM. Dorfman resides at 34 Canterbury Road, Woodbury, New York.

13. *Defendant Fernando Erazo* ("Erazo") was chief operating officer and a director of LAM from September 1974 until August 1975. During this period, he also, at various times, held the positions of president and executive vice president. Erazo resides at 15 West 84th Street, New York, New York.

COUNT I

VIOLATIONS OF SECTIONS 5(a) AND 5(c) OF THE SECURITIES ACT, 15 U.S.C. 77e(a) AND 77e(c) — OFFER, SALE AND DELIVERY AFTER SALE OF UNREGISTERED SECURITIES OF LAM

14. Plaintiff Commission realleges and incorporates by reference each and every allegation contained in paragraphs 1 through 13.

15. During the period from November 1974 to the date hereof, defendants Aaron & Co., E. Aaron, P. Aaron and Schreiber, singly and in concert, directly and indirectly, have been offering for sale, selling and delivering after sale securities, namely, the common stock of LAM and have been and are causing and inducing the offer, sale and delivery after sale of these securities.

16. Specifically, in or about November 1974 and February 1975, defendant Schreiber solicited the sale of a total of 21,000 shares of LAM common stock owned by the defendant Dorfman and a vice president of LAM.

17. Defendants P. Aaron and Schreiber arranged for these shares to be sold to an intermediary broker-dealer, J.W. Weller & Co., Inc. ("Weller & Co.") who thereafter transferred the shares to the defendant Aaron & Co.

18. In connection with these transactions Weller & Co. acted as a mere conduit and, in fact, the actual purchaser was Aaron & Co. who acquired the shares for its own proprietary account.

19. At or about the time that Aaron & Co. purchased these shares for its own account, Aaron & Co. and Schreiber solicited and arranged for the solicitation of customers' orders to buy the LAM shares sold by defendant Dorfman and the LAM vice president.

20. No registration statement as is required by Section 5 of the Securities Act has been filed with the Commission or is in effect with respect to such offers, sales or deliveries after sale of LAM common stock, as described in paragraph 16.

21. Although the defendants Aaron & Co., P. Aaron and Schreiber purportedly relied on Section 4 of the Securities Act,

15 U.S.C. 77(d), and Rule 144, 17 C.F.R. 230.144 promulgated thereunder, as the basis for not complying with the registration requirements of the Securities Act in connection with the transactions described in paragraphs 16-20 above, no such exemption was available because the transactions failed to comply with the conditions of Rule 144 in, among others, the following respects:

(a) the sales by Aaron & Co. were not made as agent for the sellers, but rather as principal for its own account and were, therefore, not made in "brokers' transactions" as required by Rule 144(f) and defined, for purposes of the Rule, by Rule 144(g);

(b) Aaron & Co. and Schreiber solicited and arranged for the solicitation of orders to buy the securities in anticipation of or in connection with the sales, in contravention of Rule 144(f)(i).

22. Defendant E. Aaron aided and abetted the violative conduct of defendants Aaron & Co., P. Aaron and Schreiber, in that he failed to prevent or terminate the type of activity in which the defendants Aaron & Co., P. Aaron and Schreiber engaged as is described above in paragraphs 15 through 21, at a time when defendant E. Aaron knew or should have known of such activity.

23. By reason of the foregoing, defendants Aaron & Co., E. Aaron, P. Aaron and Schreiber have, singly and in concert, directly and indirectly, violated and aided and abetted violations of Sections 5(a) and 5(c) of the Securities Act, 15 U.S.C. 77e(a) and 77e(c).

COUNT II

VIOLATIONS OF SECTION 17(a) OF THE SECURITIES ACT, 15 U.S.C. 77q(a).

Complaint

SECTION 10(b) OF THE EXCHANGE ACT, 15 U.S.C. 78j(b) AND RULE 10b-5 THEREUNDER, 17 C.F.R. 240.10b-5 — FRAUD IN CONNECTION WITH THE OFFER, SALE OR PURCHASE OF SECURITIES

24. Plaintiff Commission realleges and incorporates by reference each and every allegation contained in paragraph 1 through 23.

25. Since November 1974, the defendants Aaron & Co., E. Aaron, P. Aaron, Schreiber, Jacobson, LAM, Dorfman and Erazo, directly and indirectly, singly and in concert, and aiding and abetting each other, by use of the means and instruments and instrumentalities of interstate commerce and of the mails, have been and are now, employing devices, schemes and artifices to defraud, making untrue statements of material facts and omitting to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading and engaging in acts, practices and a course of business which had operated, now operates and will operate as a fraud and deceit upon purchasers and prospective purchasers in connection with the purchase, offer to sell and sale of certain securities, namely, the common stock of LAM, in violation of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b) and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

26. As part of and in furtherance of the aforesaid conduct, defendants Aaron & Co., E. Aaron, P. Aaron, Schreiber and Jacobson, singly and in concert, would and did:

(a) actively seek out investors and prospective investors and offer for sale and sell to them common shares of LAM; and

Complaint

(b) obtain money and property from over 100 investors throughout the United States for such shares by the use of false and misleading statements, as if more fully described in paragraphs 27 and 28.

27. As a part of such scheme and artifice to defraud, during the period from November 1974 to September 1975, defendants Jacobson and Schreiber in telephone conversations, letters and otherwise, made to investors and prospective investors in the securities of LAM untrue statements of material facts, including, among other things:

(a) that LAM was building a tractor and a gas saving, economy, anti-pollution, electric automobile;

(b) that LAM was about to acquire certain of its materials suppliers, an upstate New York company whose stock was selling for $3 per share and other companies;

(c) that LAM's sales revenues would be five (5) million dollars this year and twenty-five (25) million dollars in five (5) years;

(d) that the price of LAM common stock would double or triple in price within a year; and

(e) statements of similar purport and object.

28. In connection with such scheme and artifice to defraud, defendants Jacobson and Schreiber further omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, including, among other things:

(a) that the defendants had no basis to project that LAM's sales revenues would be five (5) million dollars this year and twenty-five (25) million dollars in five years;

(b) that the defendants had no basis to project that the price of LAM common stock would double or triple within a year; and

(c) that LAM was not profitable and was in need of additional capital.

29. Defendants E. Aaron and P. Aaron aided and abetted the violative conduct of defendants Aaron & Co., Schreiber and Jacobson, in that they failed to prevent or terminate the use, by Schreiber and Jacobson, of false and misleading representations, described above in paragraphs 27 and 28, in the offer and sale of LAM common stock to the public at a time when E. Aaron and P. Aaron knew or should have known of such activity.

30. In or about November of 1974 LAM caused a list of its stockholders to be supplied to the defendants Aaron & Co and Schreiber.

31. In or about January of 1975 LAM supplied a list of its franchisees to the defendants Aaron & Co. and Schreiber.

32. The two lists described above in paragraphs 30 and 31 were supplied to the defendants Aaron & Co. and Schreiber by the defendant LAM in order for the defendant Aaron & Co. to notify such persons that purchases and sales of LAM securities could be effected through the defendant Aaron & Co.

33. Thereafter, the defendant Aaron & Co. became the principal market maker in LAM's common stock.

34. Moreover, the defendants LAM, Dorfman and Erazo provided the defendants Aaron & Co., Jacobson and Schreiber with information concerning the operations and future prospects of LAM.

35. During the period from November of 1974 to September of 1975 the price of LAM's common stock rose from 13¢ per share to 88¢ per share.

36. During this same period from November 1974 to September 1975, defendants LAM, Dorfman and Erazo were repeatedly apprised of the false and misleading representations, described above in paragraphs 27 and 28, being made by defendant Jacobson and Schreiber in connection with the offer and sale of LAM common stock.

37. Nevertheless, despite having actual knowledge of these false and misleading representations, neither LAM, Dorfman nor Erazo notified any regulatory authorities, nor made any disclosure to its shareholders or franchisees whose names LAM supplied to Aaron & Co. correcting or disaffirming the inaccurate information, nor did they take any other effective action to halt or prevent the type of activity in which the defendants Aaron & Co., Jacobson and Schreiber were engaged.

38. There was no valid business purpose which justified the failure of the defendants LAM, Dorfman and Erazo to take action such as that described in paragraph 37 above.

39. By reason of the foregoing, the defendants Aaron & Co., Schreiber and Jacobson, singly and in concert, have violated, are violating and are about to violate and E. Aaron, P. Aaron, LAM, Dorfman and Erazo have aided and abetted, are aiding and abetting and are about to aid and abet violations of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b) and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5.

WHEREFORE, plaintiff Commission respectfully demands:

I. That this Court issue a preliminary injunction and final judgment of permanent injunction enjoining:

A. Defendants Aaron & Co., E. Aaron, P. Aaron and Schreiber, the officers of Aaron & Co., their agents, servants, employees, attorneys, nominees and those persons in active concert or participation with them, and each of them, from, directly or indirectly, violating or aiding and abetting violations of Sections 5(a) and 5(c) of the Securities Act, 15 U.S.C. 77e(a) and 77e(c), by directly or indirectly, in the absence of any applicable statutory exemption:

(1) making use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell, through the use or medium of any prospectus or otherwise, the common stock of LAM, or any other security, unless and until a registration statement has been filed with the Commission as to such securities;

(2) making use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell, through the use or medium of any prospectus, or otherwise, the common stock of LAM, or any other security, unless and until a registration statement is in effect with the Commission as to such securities;

(3) carrying or causing to be carried through the mails or in interstate commerce, by any means or instruments of transportation, the common stock of LAM, or any other security, for the purpose of sale or delivery after sale, unless and until a registration statement is in effect with the Commission as to such securities.

B. Defendants Aaron & Co., E. Aaron, P. Aaron, Schreiber, Jacobson, LAM, Dorfman and Erazo, the officers of

Aaron & Co. and LAM, their agents, servants, employees, attorneys, nominees, and those persons in active concert or participation with them and each of them, from, directly or indirectly, violating or aiding and abetting violations of Section 17(a) of the Securities Act, 15 U.S.C. 77q(a) and Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b) and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5 by the use of any means or instruments or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, in connection with the offer, purchase or sale of the common stock of LAM, or any other security:

(1) employing any device, scheme or artifice to defraud;

(2) making any untrue statements of a material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or

(3) engaging in any act, practice or course of business which operates as a fraud or deceit upon any person.

II. That this Court grant plaintiff such other and further relief as the Court may deem appropriate.

Respectfully submitted,

s/ William D. Moran
WILLIAM D. MORAN
Regional Administrator
Attorney for Plaintiff
SECURITIES AND
EXCHANGE COMMISSION
26 Federal Plaza
New York, New York 10007
Telephone No. : 212-264-1636

Of Counsel:
DONALD N. MALAWSKY
JEFFREY H. TUCKER
BARRY J. MANDEL
BARRY B. GLOBERMAN

Dated: New York, New York
February 26, 1976

ANSWER OF PETER AARON FILED JUNE 25, 1976

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

76 Civil 907

[TITLE OMITTED]

Defendant, Peter Aaron, by his attorney, Charles J. Hecht, for his Answer herein alleges:

1. Insofar as paragraphs 1 and 5 refer or relate to this defendant, defendant denies each and every allegation in such paragraphs. Insofar as paragraphs 1 and 5 refer to E. L. Aaron & Co. ("Aaron & Co."), Edward L. Aaron, Norman Lawrence Schreiber ("Schreiber"), Donald Darwin Jacobson ("Jacobson"), Lawn-A-Mat Chemical & Equipment Corp. ("Lawn-A-Mat"), Daniel Dorfman ("Dorfman") and Ferenando Erazo ("Erazo") defendant has insufficient knowledge or information to form a belief of the allegations referring or relating to the defendants Schreiber, Jacobson, Lawn-A-Mat, Dorfman and Erazo and based on information and belief denies each and every allegation of paragraphs 1 and 5 as they refer or relate to Edward L. Aaron and Aaron & Co.

2. Admits the allegations in paragraphs 2, 3, 4 and 6.

3. Denies sufficient knowledge or information to form a belief as to the allegations in paragraph 7 and affirmatively alleges that based upon information and belief at all times relevant hereto Lawn-A-Mat was a reporting company and that its filings were current with the Securities and Exchange Commission.

4. Defendant admits the allegations in paragraph 8.

Answer

5. Defendant admits that he is the son of Edward L. Aaron and during the relevant period referred to herein was employed by Aaron & Co., that he has been associated with Aaron & Co. since 1967 and resides at 119 State Street, Brooklyn, New York. Defendant is unable to respond to the allegation that he "functioned as office manager of Aaron & Co." since he does not know how the plaintiff is utilizing such term.

6. Defendant admits the allegations in paragraph 10 and affirmatively alleges that Schreiber was a registered principal of Aaron & Co. who was responsible for all aspects of the operation of the Long Island Branch Office of Aaron & Co.

7. Defendant admits the allegations in paragraph 11.

8. Defendant has insufficient knowledge or information to form a belief as to the allegations set forth in paragraphs 12 and 13.

9. As to paragraph 14 of the Complaint, the defendant repeats and realleges the responses set forth above.

10. Insofar as the allegations in paragraph 15 refer or relate to this defendant, the defendant denies each and every allegation contained therein. Insofar as the allegations contained in paragraph 15 refer or relate to Schreiber, the defendant has insufficient knowledge or information sufficient to form a belief. Insofar as the allegations in paragraph 15 relate to Aaron & Co. and Edward L. Aaron, based on information and belief this defendant denies such allegations except admits that subsequent to October, 1974 he was aware that Aaron & Co. maintained a market for the Common Stock of Lawn-A-Mat and that in connection with such activities directly or indirectly participated in the sale or delivery of the Common Stock of Lawn-A-Mat.

Answer

11. Based upon information and belief the defendant denies the allegations contained in paragraph 16.

12. Insofar as the allegations in paragraph 17 refer or relate to the defendant, this defendant specifically denies such allegations and affirmatively alleges that any "arrangements" with J. W. Weller & Co., Inc. were done pursuant to the advice of counsel to Aaron & Co. Insofar as the allegations in paragraph 17 refer or relate to Schreiber, defendant has insufficient knowledge or information to form a belief.

13. Defendant denies knowledge or information sufficient to form a belief as to the allegations in paragraph 18 and affirmatively alleges that any transactions with J. W. Weller & Co. were done pursuant to the advice of counsel.

14. Insofar as the allegations in paragraph 19 refer or relate to Aaron & Co. based upon information and belief defendant denies such allegations. Insofar as the allegations in paragraph 19 refer or relate to Schreiber, defendant has insufficient knowledge or information to form a belief as to the allegations.

15. As to the allegations in paragraph 20, defendant alleges that they are argumentative and are conclusions of law and, accordingly, do not require a response; but, insofar as they may be deemed to be material allegations of fact, defendant alleges that no registration statement was required by Section 5 of the Securities Act of 1933, as amended, with respect to the 21,000 shares of Common Stock of Lawn-A-Mat referred to in the Complaint.

16. As to the allegations contained in paragraph 21, defendant alleges that they are argumentative and are conclusions of law and, accordingly, do not require a response; but, insofar as they may be deemed to be material allegations of fact, defendant alleges that the 21,000 shares of Common Stock

of Lawn-A-Mat referred to in the Complaint were, based upon information and belief acquired by the record and beneficial owners prior to April 15, 1972. Accordingly, the provisions of Rule 144 (17 C.F.R. 230.144), promulgated under the Securities Act of 1933, as amended (the "Act"), need not be complied with and, in any event, based upon information and belief the alleged acts and transactions of Aaron & Co. were not in violation of said rule. Insofar as the allegations in subparagraph (b) of paragraph 21 relating to Aaron & Co., defendant alleges that based upon information and belief Aaron & Co. did not solicit or arrange for the solicitation of orders to buy the securities for its customers in anticipation of or in connection with the sales in contravention of Rule 144(f)(i). Insofar as the allegations in subparagraph (b) of paragraph 21 refer or relate to Schreiber defendant has insufficient knowledge or information to form a belief.

17. Insofar as the allegations in paragraph 22 refer or relate to this defendant, defendant denies each and every allegation. Insofar as the allegations in paragraph 22 refer or relate to Aaron & Co. and Edward L. Aaron, based upon information and belief, defendant denies each and every allegation. Insofar as the allegations in paragraph 22 refer or relate to Schreiber, defendant has insufficient knowledge or information to form a belief.

18. Defendant denies each and every allegation in paragraph 23.

19. As to paragraph 24, defendant repeats and realleges as if set forth in full herein his responses contained in paragraphs 1 through 18, inclusive.

20. Insofar as the allegations in paragraph 25 refer or relate to this defendant, defendant denies each and every allegation. Insofar as the allegations contained in paragraph 25 refer or

relate to Aaron & Co. and Edward L. Aaron, based upon information and belief, defendant denies each and every allegation. Insofar as the allegations in paragraph 25 refer or relate to the defendants, Schreiber, Jacobson, Lawn-A-Mat, Dorfman and Erazo, defendant has insufficient knowledge or information to form a belief.

21. Insofar as the allegations in paragraph 26 refer or relate to this defendant, defendant denies each and every allegation. Insofar as the allegations in paragraph 26 refer or relate to Edward L. Aaron, based upon information and belief, defendant denies each and every allegation. Insofar as the allegations in paragraph 26 refer or relate to Aaron & Co., based upon information and belief, defendant denies such allegations except he admits that subsequent to October, 1974, Aaron & Co. maintained a market for the Common Stock of Lawn-A-Mat and did participate in the purchase and sale of the Common Stock of Lawn-A-Mat. Insofar as the allegations in paragraph 26 refer or relate to Schreiber and Jacobson, defendant has insufficient knowledge or information to form a belief.

22. As to the allegations contained in paragraph 27, the defendant alleges that they are argumentative and are conclusions of law and, accordingly, do not require a response; but, insofar as they may be deemed to be material allegations of fact, defendant alleges as follows:

(a) that based upon information and belief Lawn-A-Mat and/or persons affiliated with it had furnished information to Aaron & Co. that it was entering into the following new lines of business: (i) the manufacture and distribution of a new type of tractor and (ii) the manufacture and distribution of a new automobile and that a company affiliated with Lawn-A-Mat had entered into a "Letter of Intent" with Aaron & Co. for the latter to act as its underwriter in connection with a proposed

offering of additional securities, the net proceeds of which would primarily be utilized for the financing of these proposed additional lines of business.

(b) defendant denies knowledge or information sufficient to form a belief as to subparagraphs (b), (c), (d) and (e) and affirmatively alleges that if such representations were made by Schreiber and Jacobson they were made without the knowledge or consent of defendant, Edward L. Aaron and Aaron & Co. and that such alleged representations were in contravention of Aaron & Co's. internal compliance manual.

23. As to the allegations contained in paragraph 23, defendant alleges that they are argumentative and are conclusions of law and, accordingly, do not require a response; but, insofar as they may be deemed to be material allegations of fact, defendant alleges that at all times material herein he was unaware of the alleged false and misleading representations as described in subparagraph (b) through (e) of paragraph 27 of the Complaint and that any such alleged misrepresentations by Schreiber and Jacobson were in contravention of the internal compliance manual of Aaron & Co.

24. As to the allegations contained in paragraph 24, defendant alleges that they are argumentative and are conclusions of law and, accordingly, do not require a response; but, insofar as they may be deemed to be material allegations of fact, defendant specifically denies such allegations and affirmatively alleges that upon being advised by Milton Kean, counsel to Lawn-A-Mat, of possible improprieties by the Long Island office of Aaron & Co., defendant immediately informed an officer of Aaron & Co. of Mr. Kean's concern and pursuant to the instructions of an officer of Aaron & Co. immediately notified the registered principal of the Long Island office to

cease all solicitations of the Common Stock of Lawn-A-Mat and was advised by such registered principal that these instructions would be followed.

25. Based upon information and belief defendant denies the allegations set forth in paragraph 30 insofar as they relate to Aaron & Co. and affirmatively alleges that if such stockholders list was caused to be furnished by Lawn-A-Mat, it was furnished to Schreiber and/or Jacobson.

26. Based upon information and belief defendant denies the allegations contained in paragraph 31 insofar as they relate to Aaron & Co. and affirmatively alleges that if such list of franchisees was furnished by Lawn-A-Mat, it was furnished to Schreiber and/or Jacobson.

27. As to the allegations contained in paragraph 32, defendant alleges that they are argumentative and are conclusions of law and, accordingly, do not require a response; but, insofar as they may be deemed to be material allegations of fact, defendant alleges, based upon information and belief, subsequent to October, 1974, Aaron & Co. maintained a market for the Common Stock of Lawn-A-Mat.

28. Defendant has insufficient knowledge or information to form a belief as to the allegations contained in paragraph 33 except that based upon information and belief Aaron & Co. maintained a market for the Common Stock of Lawn-A-Mat subsequent to October, 1974.

29. Based upon information and belief defendant admits the allegations in paragraph 34.

30. Defendant has insufficient knowledge or information to form a belief as to the allegations in paragraphs 35 and 36.

Answer

31. As to the allegations contained in paragraph 37 defendant alleges that they are argumentative and are conclusions of law and, accordingly, do not require a response; but, insofar as they may be deemed to be material allegations of fact, defendant alleges as follows:

(a) denies knowledge or information sufficient to form a belief as to such allegations insofar as they relate to Lawn-A-Mat, Dorfman and Erazo.

(b) that based upon information and belief the names of shareholders or franchisees of Lawn-A-Mat were only furnished to Schreiber and/or Jacobson.

(c) insofar as such allegations relate to Aaron & Co., Jacobson and Schreiber, defendant has insufficient knowledge or information to form a belief.

32. As to the allegations contained in paragraph 38, defendant alleges that they are argumentative, are conclusions of law and are not applicable to this defendant and, accordingly, do not require a response; but, insofar as they may be deemed to be material allegations of fact, the defendant denies knowledge or information sufficient to form a belief.

33. Insofar as paragraph 39 refers or relates to this defendant, defendant denies each and every allegation in such paragraph. Insofar as the allegations in paragraph 39 refer or relate to Edward L. Aaron and Aaron & Co., based upon information and belief, defendant denies each and every allegation. Insofar as paragraph 39 refers to Schreiber, Jacobson, Lawn-A-Mat, Dorfman and Erazo, defendant has insufficient knowledge or information to for a belief as to the allegations set forth in paragraph 39.

Answer

AS AND FOR A FIRST AFFIRMATIVE DEFENSE

34. Based upon information and belief the 21,000 shares of Common Stock of Lawn-A-Mat referred to in the Complaint were purchased by the record and beneficial owners (Dorfman and a Vice-President of Lawn-A-Mat) prior to April 15, 1972 and as at November 1974 such persons had been the record and beneficial owners of such securities for more than three years.

35. Under the rules and regulations promulgated under the Act, as well as the interpretive releases then in effect, such persons would not be deemed to be underwriters as that term is defined by Section 2(11) of the Act and thus, compliance with the provisions of Rule 144 are elective and not mandatory.

36. Even if Rule 144 is deemed exclusively applicable to the alleged acts and transactions relating to the sale of 21,000 shares of Common Stock of Lawn-A-Mat the term "brokers' transactions", as used in Rule 144(f), is defined and explained in 144(g)(2) and that based upon information and belief the acts and transactions of Aaron & Co. came within the exclusions set forth in Rule 144(g)(2).

37. Defendant also alleges that it was common practice in the brokerage industry with respect to substantial blocks of low-priced stocks that for the benefit of the record owners of such stocks arrangements were made with brokerage houses located outside of the State of New York to purchase such shares so that the record owner would not be liable for substantial New York State Transfer taxes on said transactions and, as such, such arrangements have never been deemed a violation of any provision of the federal securities laws.

38. By reason of the foregoing there are no violations of Section 5(a) and 5(c) of the Securities Act of 1933, as amended.

Answer

AS AND FOR A SECOND
AFFIRMATIVE DEFENSE

39. Defendant alleges that at all times relevant hereto he was not an officer, director, stockholder or registered principal of Aaron & Co. and, thus, would not be deemed a controlling person as such term is defined by Section 20 of the Securities Exchange Act of 1934, as amended.

40. Defendant alleges that he did not directly or indirectly induce the alleged act or acts constituting the alleged violations as set forth in the causes of action alleged in the Complaint.

41. By reason of the foregoing the defendant did not violate or aid and abet violations of Section 17(a) of the Securities Act of 1933, as amended, and Section 10(b) of the Exchange Act and 10b-5 promulgated thereunder.

AS AND FOR A THIRD
AFFIRMATIVE DEFENSE

42. Defendant alleges that at all times relevant herein Schreiber was the registered principal who was responsible for supervising himself and all other registered representatives employed at the Long Island Branch Office of Aaron & Co. To the extent there are any violations of the various provisions of the federal securities laws relating to the operations of that office they were the primary responsibility of Schreiber.

44. That if in fact Schreiber and Jacobson committed the acts and transactions alleged in the Complaint, such acts and transactions were not within the scope or authority of their employment.

45. That at all times relevant hereto this defendant did not directly or indirectly supervise the conduct of the registered representatives of Aaron & Co.

Answer

46. By reason of the foregoing the defendant did not aid and abet the other defendants to the extent it is found that the other defendants violated Section 17(a) of the Act, Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

WHEREFORE, the defendant, Peter E. Aaron, respectfully demands that this Court deny in all respects the plaintiff's demand for a preliminary injunction and final judgment of permanent injunction and such other and further relief as the Court may deem just and proper under the circumstances.

Respectfully submitted,

s/ Charles J. Hecht
Charles J. Hecht
Attorney for Peter E. Aaron
Suite 1760, 60 E. 42nd St.
New York, N.Y. 10017
(212) 490-3232

Dated: New York, New York
June 25, 1976

CERTIFICATE OF SERVICE

I hereby certify that I am an attorney at law admitted to practice in the State of New York, and that on the 25th day of June, 1976, I caused to be served by United States mail postage prepaid, one copy of the attached Answer upon William D. Moran, Regional Administrator, New York Regional Office, Securities and Exchange Commission, 26 Federal Plaza, New York, New York 10007.

A review of the files of this case at the United States District Courthouse for the Southern District of New York at Foley Square on June 25, 1976 indicates that all of the other

defendants herein, exclusive of Lawn-A-Mat Chemical & Equipment Corp. have consented to the issuance of injunctions and as to that defendant I have been advised by Jeffrey Zivyak of Berman & Zivyak that their client has agreed in principle to an injunction and they are awaiting approval of Judge Ruden before filing the same with this Court and that in connection therewith they do not desire a copy of the Answer of Peter Aaron. Accordingly, copies of the Answer were not served on counsel to the other defendants herein.

Dated: New York, New York
June 25, 1976

Respectfully submitted,

s/ Charles J. Hecht
Charles J. Hecht
Attorney for Peter E. Aaron
Suite 1760
60 East 42nd Street
New York, N.Y. 10017
(212) 490-3232

THE SUPREME COURT'S ORDER GRANTING REVIEW

OFFICE OF THE CLERK

SUPREME COURT OF THE UNITED STATES

WASHINGTON, D.C. 20543

October 15, 1979

Barry M. Fallick, Esq.
230 Park Avenue
New York, N.Y. 10017

RE: Peter E. Aaron v. Securities and Exchange Commission, No. 79-66

Dear Mr. Fallick:

The Court today took the following action in the above case:

"The petition for a writ of certiorari is granted."

Enclosed are memorandums describing the time requirements and procedures under the rules.

The additional docketing fee of $50, Rule 52(a), is due and payable.

Very truly yours,

MICHAEL RODAK, JR., Clerk

by June M. Hoffman
(Miss) June M. Hoffmann
Assistant Clerk

Enclosures

FILED
SEP 20 1979
MICHAEL RODAK, JR., CLERK

No. 79-66

In the Supreme Court of the United States

OCTOBER TERM, 1978

PETER E. AARON, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

RALPH C. FERRARA
General Counsel

JACOB H. STILLMAN
Associate General Counsel

ELISSE B. WALTER
Assistant General Counsel

LARRY R. LAVOIE
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Securities and Exchange Commission
Washington, D.C. 20549

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In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 79-66

PETER E. AARON, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-29a) is not yet officially reported. The opinion of the district court (Pet. App. 30a-50a) is not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1979. On June 11, 1979, Mr. Justice Marshall extended the time to file a petition for a writ of certiorari to and including July 10, 1979, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), requires proof of *scienter* in an injunctive proceeding brought by the Securities and Exchange Commission.

2. Whether Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, require proof of *scienter* in an injunctive proceeding brought by the Securities and Exchange Commission.

STATEMENT

In February 1976 the Securities and Exchange Commission filed a complaint in the United States District Court for the Southern District of New York against eight defendants, including petitioner,[1] alleging violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. 240.10b-5, in connection with the offer and sale of common stock of Lawn-A-Mat Chemical & Equipment Corp. ("Lawn-A-Mat") (Pet. App. 31a).[2] Petitioner had

[1]Each defendant except petitioner consented to the entry of a permanent injunction (Pet. App. 31a).

[2]The complaint also charged petitioner and three other defendants with violations of registration provisions of the federal securities laws, Section 5(a) and (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) and (c) (Pet. App. 31a). The district court found that petitioner had violated the registration provisions and enjoined him from future violations (Pet. App. 40a-44a). The court of appeals affirmed this disposition, noting that petitioner had arranged a sham transaction in order to create the appearance of an exemption from the registration provisions (Pet. App. 10a-13a, 21a). Petitioner does not raise in his petition any question concerning the judgment insofar as it enjoins him from future violations of the registration provisions.

supervisory responsibility over the employees of a broker-dealer firm registered with the Commission (Pet. App. 32a-33a).[3] The complaint alleged that petitioner violated and aided and abetted violations of the antifraud provisions in that he knew or should have known that employees of the broker-dealer firm were making materially false and misleading representations in the offer and sale of Lawn-A-Mat stock, but he failed to take steps to prevent or terminate the fraudulent activity (J.A. 3, 8-12).[4] Following a three-day evidentiary hearing, the district court found that petitioner had violated Section 17(a), Section 10(b), and Rule 10b-5, and enjoined him from future violations of those provisions (Pet. App. 31a, 45a).

The court of appeals affirmed (Pet. App. 21a). Addressing Section 10(b) and Rule 10b-5, the court rejected petitioner's contention that *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976)—which held that *scienter* is a necessary element of a private damage action under those provisions—compels the conclusion that *scienter* is also a necessary element in a Commission injunctive proceeding. Concluding that proof of *scienter* is not required in such a proceeding, the court of appeals found it "unnecessary to reach the question whether [petitioner's] conduct would support a finding of scienter * * *" (Pet. App. 13a).[5]

[3]Petitioner does not challenge the findings of the court of appeals and the district court (Pet. App. 4a, 8a, 33a) that he had managerial and supervisory responsibility over the firm's activities and employees.

[4]"J.A." refers to the joint appendix in the court of appeals.

[5]The district court had found that petitioner's misconduct was "sufficient to establish his scienter * * *" (Pet. App. 13a, 40a).

In declining to adopt a *scienter* requirement for Commission injunctive proceedings brought under Section 10(b) and Rule 10b-5, the court of appeals analyzed the factors considered by this Court in the context of private damage litigation in *Hochfelder*—the language of Section 10(b), the legislative history of the Securities Exchange Act, the relationship between Section 10(b) and the express private remedy provisions of the securities laws, and the effect of a *scienter* standard on the overall enforcement scheme contemplated by the securities laws. Noting that "different courts have construed the language [of Section 10(b)] differently," the court concluded that the language of the section alone was not dispositive of the issue (Pet. App. 16a). The court also concluded that the legislative history of the Securities Exchange Act shows that Congress did not intend to require *scienter* in Commission injunctive suits (Pet. App. 17a-18a). Finally, the court found rejection of a *scienter* requirement to be consistent with the statutory enforcement scheme (Pet. App. 18a). In this regard the court observed that, unlike the situation in *Hochfelder*, no provisions of the federal securities laws would be "nullified" by permitting Commission injunctive proceedings predicated on a showing of negligence[6] and that a negligence standard in such proceedings would harmonize Section 10(b) with "similar prophylactic provisions" of the Securities Act of 1933 (Pet. App. 19a). Apart from its analysis of

[6]In *Hochfelder*, this Court noted that the statutory provisions expressly allowing private recovery for negligent conduct, Sections 11, 12(2), and 15 of the Securities Act of 1933, 15 U.S.C. 77k, 77l(2), and 77o, are "subject to significant procedural restrictions not applicable under [Section] 10(b)." 425 U.S. at 209-210. An extension of the remedies under Section 10(b) to actions premised on negligent wrongdoing, the Court concluded, would "nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." 425 U.S. at 210.

Hochfelder, the court of appeals reaffirmed the view, expressed in its prior decisions, that in light of the essential purpose of injunctive relief—"to protect the public against harm, not to punish the offender" (Pet. App. 16a, quoting *SEC* v. *Coven*, 581 F. 2d 1020, 1027-1028 (2d Cir. 1978), cert. denied, No. 78-956 (Mar. 5, 1979))—the increased protection to investors resulting from a negligence standard in government injunctive proceedings outweighed any potential harm to those enjoined for their negligence (Pet. App. 15a).

The court of appeals also rejected a *scienter* requirement for Commission injunctive proceedings brought under Section 17(a), relying on its prior decision in *SEC* v. *Coven*, *supra* (Pet. App. 19a). In *Coven*, the court of appeals observed that Section 17(a) does not contain any language comparable to the phrase "manipulative or deceptive device or contrivance" in Section 10(b) and that there is thus no reason to give the provision a "narrow reading." 581 F. 2d at 1026-1027. The *Coven* court also noted that the legislative history of Section 17(a) indicates that Congress had considered a *scienter* requirement but "opted for liability without willfulness, intent to defraud, or the like, in enacting §17(a)." *Id.* at 1027.

DISCUSSION

The court of appeals correctly determined that proof of *scienter* is not required in a Commission injunctive proceeding brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder or under Section 17(a) of the Securities Act. Nevertheless, in view of the importance of these issues to the administration of the federal securities laws, the extraordinary amount of time expended in litigating these issues, and the disagreement among the lower courts concerning the need to prove *scienter* in Commission injunctive proceedings, the Commission believes that the Court should grant the petition for a writ of certiorari in this case.

1. The issues raised by petitioner—whether the Commission is required to prove *scienter* on the part of a defendant in an action seeking injunctive relief against future violations of Section 10(b) or Section 17(a)—are important. The imposition of a *scienter* requirement in all Commission proceedings brought to prevent recurrence of conduct that operates as a fraud or deceit on public investors, and the resulting difficulty in proving a defendant's state of mind, "would effectively nullify the protective purposes" of the federal securities statutes. Cf. *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 200 (1963).

The Commission is charged with enforcing the federal securities laws for the protection of investors. Unlike a private plaintiff seeking to recover damages he has incurred, the Commission, in seeking an injunction, does not sue to vindicate its own rights; rather, it endeavors to protect the public interest and the interests of investors from violations of the law by obtaining prospective relief that requires the defendant to obey the securities laws in the future.[7] "An injunction is designed to protect the public against conduct, not to punish a state of mind."[8] The harm caused by a defendant's deceptive conduct in

[7]In a Commission enforcement action, "the standards of the public interest not the requirements of private litigation measure the propriety and need for injunctive relief." *SEC* v. *Management Dynamics, Inc.*, 515 F. 2d 801, 808 (2d Cir. 1975), quoting *Hecht Co.* v. *Bowles*, 321 U.S. 321, 331 (1944). When the Commission seeks an injunction charging a past violation of the law, the courts generally require proof of a reasonable likelihood that the wrong will be repeated. See, *e.g.*, *SEC* v. *Koracorp Industries, Inc.*, 575 F. 2d 692, 698-699 (9th Cir.), cert. denied, 439 U.S. 953 (1978), quoting 3 L. Loss, *Securities Regulation* 1976 (2d ed. 1961); *SEC* v. *Management Dynamics, Inc.*, *supra*, 515 F. 2d at 808.

[8]*SEC* v. *World Radio Mission, Inc.*, 544 F. 2d 535, 541 (1st Cir. 1976).

securities transactions does not depend on his state of mind. As the court noted in *SEC* v. *Coven*, *supra*, 581 F. 2d at 1028, the "effects [of negligent conduct] on the public may be every bit as detrimental as those produced by intentional misconduct." If the Commission were required to prove in every injunctive proceeding alleging violation of the antifraud provisions of the federal securities laws that the defendant acted with an "intent to deceive, manipulate, or defraud,"[9] the Commission's ability to enforce the federal securities laws would be eroded significantly and investors would be deprived of needed protections.

2. In the three and a half years since *Hochfelder* was decided, the question expressly reserved by this Court in that case—"whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5" (425 U.S. at 194 n.12)—and the related question whether *scienter* is required in an injunctive proceeding under Section 17(a), have been the subject of substantial litigation, as evidenced by the fact that there have been at least 25 reported decisions in which the *scienter* requirement was raised as an issue.[10] In proceedings for injunctive relief brought under Section 10(b) and Rule 10b-5, there has been great uncertainty in the courts of

[9]*Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 188.

[10]See notes 11-13, *infra*.

appeals[11] and the district courts[12] as to whether *scienter* is an element. While the courts of appeals and most district

[11]Since this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), the First and Second Circuits have expressed the view that *scienter* is not required in Commission injunctive actions under Section 10(b). The Fifth Circuit has disagreed. Compare the court of appeals decision in this case (Pet. App. 13a-19a) and *SEC* v. *World Radio Mission, Inc.*, *supra*, 544 F. 2d at 540-541 & n.10, with *SEC* v. *Blatt*, 583 F. 2d 1325, 1333-1334 (5th Cir. 1978). The Ninth Circuit has assumed, without deciding, that *scienter* is not required under Section 10(b) in Commission injunctive actions. *SEC* v. *Arthur Young & Co.*, 590 F. 2d 785, 787 (1979); *SEC* v. *Koracorp Industries, Inc.*, *supra*, 575 F.2d at 701. Other courts of appeals have reserved decision on the issue. See, *e.g.*, *SEC* v. *Savoy Industries, Inc.*, 587 F. 2d 1149, 1172 (D.C. Cir. 1978), cert. denied, No. 78-932 (Feb. 21, 1979) (remanded for further consideration); *SEC* v. *American Realty Trust*, 586 F. 2d 1001, 1002 (4th Cir. 1978) (findings of violations on the basis of Section 17(a) only).

[12]Some district courts have expressed the view that *scienter* is not required in Commission injunctive actions under Section 10(b). *SEC* v. *Chatham*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,911 at 95,758 (D. Utah June 6, 1979); *SEC* v. *Paro*, 468 F. Supp. 635, 647-649 (N.D. N.Y. 1979); *SEC* v. *Western Geothermal & Power Corp.*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,920 at 95,859 (D. Ariz. May 23, 1979), appeal pending, No. 79-3422 (9th Cir.); *SEC* v. *Hart*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,454 at 93,645 (D.D.C. May 26, 1978); *SEC* v. *Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1978), aff'd, 590 F. 2d 785 (9th Cir. 1979); *SEC* v. *Shiell*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,190 at 92,386 (N.D. Fla. Sept. 27, 1977); *SEC* v. *Trans Jersey Bancorp.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 95,818 at 90,950 (D.N.J. Dec. 14, 1976).

Other district courts have indicated that *scienter* is required under Section 10(b). *SEC* v. *Wills*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,712 at 94,769-94,770 (D.D.C. Dec. 14, 1978); *SEC* v. *Randell*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,362 (E.D. Va. Feb. 24, 1978), appeal pending, No. 78-1386 (4th Cir.); *SEC* v. *Southwest Coal & Energy Co.*, 439 F. Supp. 820, 825 (W.D. La. 1977), appeal pending, No. 78-1130 (5th Cir.); *SEC* v. *Cenco Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC* v. *American Realty Trust*, 429 F. Supp. 1148, 1171 (E.D. Va. 1977), rev'd on other grounds, 586 F. 2d 1001 (4th Cir. 1978); *SEC* v. *Bausch & Lomb Inc.*, 420 F. Supp. 1226, 1241 (S.D. N.Y. 1976), aff'd on other grounds, 565 F. 2d 8 (2d

courts addressing the issue have agreed that *scienter* is not required under Section 17(a), the issue is nonetheless continually litigated.[13]

Cir. 1977). In other cases in which the *scienter* issue has been raised, district courts have reserved decision. *SEC* v. *National Student Marketing Corp.*, 457 F. Supp. 682, 709-710 (D.D.C. 1978), appeals pending, Nos. 79-1051-1053 (D.C. Cir.); *SEC* v. *Jos. Schlitz Brewing Co.*, 452 F. Supp. 824, 831 (E.D. Wisc. 1978); *SEC* v. *Penn Central Co.*, 450 F. Supp. 908, 917-918 (E.D. Pa. 1978); *SEC* v. *Falstaff Brewing Corp.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,583 at 94,471 (D.D.C. Oct. 28, 1978), appeal pending, No. 79-1467 (D.C. Cir.); *SEC* v. *Technical Resources, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,268 at 92,744 (S.D.N.Y. Dec. 22, 1977), aff'd without opinion, No. 78-6046 (2d Cir. Nov. 28, 1978).

[13]The court of appeals in this case and the other courts of appeals that have considered the issue after *Hochfelder* have concluded that *scienter* is not required in a Commission injunctive action under Section 17(a). Pet. App. 19a-20a; *SEC* v. *American Realty Trust*, *supra*, 586 F. 2d at 1006-1007; *SEC* v. *Coven*, *supra*, 581 F. 2d at 1026-1027; *SEC* v. *World Radio Mission, Inc.*, *supra*, 544 F. 2d at 540-541. See also *SEC* v. *Arthur Young & Co.*, *supra*, 590 F. 2d at 787 (assuming *scienter* is not required under Section 17(a)).

Most district courts have concluded that *scienter* is not required under Section 17(a). See, *e.g.*, *SEC* v. *Chatham*, *supra*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,911 at 95,758; *SEC* v. *Paro*, *supra*, 468 F. Supp. at 647-649; *SEC* v. *Wills*, *supra*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,712 at 94,770; *SEC* v. *Jos. Schlitz Brewing Co.*, *supra*, 452 F. Supp. at 831; *SEC* v. *Century Mortgage Co.*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,777 at 95,053 (D. Utah Jan. 17, 1979); *SEC* v. *Western Geothermal & Power Corp.*, *supra*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,920 at 95,859; *SEC* v. *Southwest Coal & Energy Co.*, *supra*, 439 F. Supp. at 826; *SEC* v. *Geotek*, *supra*, 426 F. Supp. at 726; *SEC* v. *Shiell*, *supra*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,190 at 92,386. But see *SEC* v. *Cenco Inc.*, *supra*, 436 F. Supp. at 200; *SEC* v. *American Realty Trust*, *supra*, 429 F. Supp. at 1171; *SEC* v. *Randell*, *supra*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,362. In several recent cases, district courts have reserved decision on this issue. *SEC* v. *National Student Marketing Corp.*, *supra*, 457 F. Supp. at 709-710; *SEC* v. *Penn Central Co.*, *supra*, 450 F. Supp. at 917-918; *SEC* v. *Technical Resources, Inc.*, *supra*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) para. 96,268 at 92,744.

Resolution by this Court of the basic question whether *scienter* must be proven in Commission injunctive proceedings brought under Section 10(b) or Section 17(a) would bring certainty to the administration of the federal securities laws[14] and would conserve the resources now being expended by the courts and parties, including the Commission, in litigating these issues.[15] As the court below observed with respect to Section 10(b), the question whether *scienter* is required in Commission injunctive actions under that provision is one "on which the final word will not rest with [the lower courts]" (Pet. App. 28a n.16, quoting *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F. 2d 90, 101 (2d Cir. 1978) (Friendly, J.)). That observation is likewise applicable to Section 17(a).

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[14]Uncertainty as to the *scienter* requirement has also extended to other types of proceedings. For administrative proceedings involving Section 10(b) and Section 17(a) where *scienter* has been an issue, see *Whitney* v. *SEC*, [Current] Fed. Sec. L. Rep. (CCH) para. 96,913 (D.C. Cir. June 28, 1979) (Section 10(b) only); *Mawod & Co.* v. *SEC*, 591 F. 2d 588 (10th Cir. 1979); *Berdahl* v. *SEC*, 572 F. 2d 643 (8th Cir. 1978); *Nassar & Co.* v. *SEC*, 566 F. 2d 790 (D.C. Cir. 1977); *Collins Securities Corp.* v. *SEC*, 562 F. 2d 820 (D.C. Cir. 1977); *Arthur Lipper Corp.* v. *SEC*, 547 F. 2d 171 (2d Cir. 1976), rehearing denied, 551 F. 2d 915 (1977), cert. denied, 434 U.S. 1009 (1978) (Section 10(b) only).

[15]The question whether *scienter* is required under Section 10(b) or Section 17(a) has been raised in the following cases now pending before the courts of appeals: *SEC* v. *Falstaff Brewing Corp.*, Nos. 79-1467 (D.C. Cir.) (Section 10(b) only); *SEC* v. *National Student Marketing Corp.*, Nos. 79-1051-1053 (D.C. Cir.); *SEC* v. *Monarch Fund*, No. 79-6048 (2d Cir.) (Section 10(b) only); *SEC* v. *Mumford*, No. 78-1386 (4th Cir.); *Steadman* v. *SEC*, No. 77-2415 (5th Cir.) (administrative proceeding); *SEC* v. *Southwest Coal & Energy Co.*, No. 78-1130 (5th Cir.); *SEC* v. *Intertie, Inc.*, No. 78-3300 (9th Cir.); *SEC* v. *Blazon Corp.*, Nos. 77-1904, 77-2033 (9th Cir); *SEC* v. *Western Geothermal & Power Corp.*, No. 79-3422 (9th Cir.); *SEC* v. *Haswell*, No. 78-1048 (10th Cir.).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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In The

Supreme Court of the United States

October Term, 1979

No. 79-66

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR PETITIONER

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BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (A1-A29)* is not yet officially reported. The opinion of the district court (A30-A50) is not officially reported.

* Parenthetical references "A " refer to pages of the appendix to the printed petition for a writ of certiorari; " a" refer to appendix accompanying this brief for petitioner.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1979. On June 11, 1979, Mr. Justice Marshall extended the time within which to file a petition for a writ of certiorari to and including July 10, 1979. The petition for a writ of certiorari was filed on that date and was granted on October 15, 1979. The jurisdiction of this Court rests upon 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Whether the Securities and Exchange Commission is required to establish scienter as an element of a government enforcement action to enjoin violations of Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. §78j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5 (1975).

2. Whether the Securities and Exchange Commission is required to establish scienter as an element of a government enforcement action to enjoin violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. §77q(a).

STATEMENT

This appeal presents questions with respect to whether scienter is a necessary element in injunctive actions brought by the Securities and Exchange Commission (hereinafter referred to as "Commission") to enforce violations of Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933.[1]

---

1. The Securities and Exchange Commission is authorized by §21(d) of the 1934 Act to bring injunctive actions to enforce the statute and rules promulgated thereunder, 15 U.S.C. §78u(d)(a) (1975). Likewise, the Commission is authorized by §20(b) of the 1933 Act to bring injunctive actions to enforce the statute, 15 U.S.C. §77t(b) (1976).

The Securities and Exchange Commission brought this action for preliminary and final injunctive relief pursuant to Section 20(b) of the 1933 Act, 15 U.S.C. §77t(b) (1976), and Section 21(d) of the 1934 Act, 15 U.S.C. §78u(d)(a)(1976). The complaint filed on February 26, 1976 charged Aaron and three other defendants with violating and aiding and abetting violations of the registration provisions of §§5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§77e(a) and 77(e)(c) (1976) (13a-15a). The complaint also alleged that Aaron and seven other defendants[2] violated the anti-fraud provisions of both acts, Section 17(a) of the 1933 Act, 15 U.S.C. §77q(a) (1970), Section 10(b) of the 1934 Act, 15 U.S.C. §78j(b) (1970), and of Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5 (1971), in connection with the offer and sale of common stock of Lawn-A-Mat Chemical & Equipment Corp (15a-21a). Specifically, the complaint alleged that Aaron, who was an employee and assistant to the President of E. L. Aaron & Co., Inc., a broker-dealer registered with the Commission, exercised managerial and supervisory authority over E. L. Aaron & Co., Inc.'s registered representatives. In this connection, it was charged that petitioner, after being informed that employees of the broker-dealer firm were making false and misleading statements in connection with their attempts at selling LAM stock, did nothing to stop the false and misleading misrepresentations from being made by the employees (16a-19a). After a three day evidentiary hearing in the Southern District of New York, the district court concluded that Aaron had violated the anti-fraud provisions of the 1933 and 1934 Acts and the registration provisions of the 1933 Act (A37-A45).

In addition, the district court found that "while Aaron himself did not make any misrepresentations, by failing to stop Schreiber and Jacobson, he willfully aided and abetted their violations of the anti-fraud provisions of the securities laws" (A39-A40). Moreover, the district court also determined that:

---

2. The seven other defendants other than Aaron consented to the entry of permanent injunction against them.

> "While negligence alone may suffice as a standard for liability in Commission enforcement proceedings, the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws." (Citations omitted.) (A40).

Accordingly, the court permanently enjoined Aaron from further such violations (A44-A45).

The judgment rendered by the district court was affirmed by the court of appeals. It held, in short, that in the context of an enforcement action brought by the Commission to enjoin violations of either §10(b) or §17(a), proof of scienter, on the part of the defendant is not required.

In reliance upon its "carefully reasoned pre-*Hochfelder*[3] decisions", the language and history of Section 10b, and the compelling distinction between private damage actions and government injunction actions, the court of appeals held that "the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement actions brought under 10(b) of the 1934 Act and §17(a) of the 1933 Act" (A13-A19).[4]

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3. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that proof of scienter is a necessary element in a private damage action under §10(b). This Court also stated:

> "Since this case concerns an action for damages, we also need not consider the questions whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5. *Cf. SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 11 L at 2d 237, 84 S. Ct. 275 (1963)." 425 U.S. at 194 n. 12.

4. The court of appeals also stated,

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In so holding, the court of appeals conceded that its interpretation of §10(b) conflicts with that adopted by the Fifth Circuit in *SEC v. Blatt*, 583 F. 2d 1325, 1333 (5th Cir. 1978). The court found that "the language of Section 10(b) alone is not determinative of the issue and that resort to legislative history and purpose is proper" (A16).[5] In discussing the legislative history, the court of appeals examined §21(d) of the 1934 Act, the explicit statutory provision which authorizes the Commission to bring an injunctive action. It found that Congress expressly indicated at the time of the enactment of §21(d) that Commission injunctive actions are exempt from the scienter requirement application to private action (A17-A18).

In addition, the court of appeals held that policy considerations underlying the Securities Acts clearly reflect that a negligence standard should be applied in a government enforcement action (A18-A19). These holdings completely conflict with *Blatt*. There, the Fifth Circuit held that the language and history of §10(b) as analyzed and discussed in *Hochfelder*, conclusively demonstrates that scienter is a necessary element in a government enforcement action. 583 F. 2d 1332. The Fifth Circuit further stated that the language of §10(b) is sufficiently clear in its context, and thus controlling, notwithstanding considerations of public policy. 583 F. 2d 1332.

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> "We find it unnecessary to reach the question whether Aaron's conduct would support a finding of scienter, since we hold that the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement actions brought under §§10(b) and 21(d) of the 1934 Act." (A13-A14).

5. In *Hochfelder*, at 214, n. 33, this Court stated,

> "As we find the language and history of §10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of 'policy', set forth by the parties, that may have influenced the lawmakers in their formulation of the statute."

Thus, the conflict between the decision below and *Blatt* is complete.[6]

Moreover, the court of appeals, relying on its discussion of §10(b) and its previous analysis in *SEC v. Coven*, 581 F. 2d 1020, 1026-1028 (2d Cir. 1978), held that scienter is not required in a Commission injunctive action under §17(a) (A19-A20).[7]

SUMMARY OF ARGUMENT

The issue before this Court is whether the Securities and Exchange Commission must allege and prove scienter in actions for injunctive relief for violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that proof of scienter is a necessary element in a private damage action under Section 10(b). This Court, in *Hochfelder*, based its conclusion primarily on the statutory text

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6. The Tenth Circuit has apparently followed the Fifth Circuit in finding that scienter is a necessary element of a government enforcement action. *Edward J. Mawod & Co. v. SEC*, 591 F. 2d 588, 595 (10th Cir. 1979). *See also, SEC v. Willis*, ___ F. Supp. ___ (D.D.C. 12/14/78). Scienter is an essential element of a SEC injunctive action under Section 10(b). *SEC v. Cenco, Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1241 (S.D.N.Y.), *aff'd on different grounds*, 565 F. 2d 8 (2d Cir. 1977).

The First and Ninth Circuits, however, have held that negligence is the appropriate standard in a government enforcement action. *SEC v. World Radio Mission*, 544 F. 2d 535, 541 n. 10 (1st Cir. 1976); *SEC v. Arthur Young & Co.*, No. 77-1768 at 3 (9th Cir. 1979); *see also, SEC v. Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1976).

7. Subsequent to the court of appeals decision, the Fifth Circuit Court of Appeals in *Steadman v. Securities and Exchange Commission*, ___ F. 2d ___ (5th Cir. Oct. 4, 1979), held that scienter is an element of a violation of subsection 17(a)(1).

of Section 10(b), the legislative history, its setting within the statutory scheme of the 1933 and 1934 Acts, and the administrative history of Rule 10b-5. Since private damage actions and enforcement proceedings both must rely upon the same language and history of Section 10(b), identical elements of proof are required for the two types of actions. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 217-218 (1976) (Blackmun, J., dissenting); *Securities and Exchange Commission v. Blatt*, 583 F. 2d 1325, 1333 (5th Cir. 1978). In addition, the policy considerations present in Commission injunctive actions do not justify applying a different standard from that required in private damage actions. *Ernst & Ernst v. Hochfelder*, 425 U.S. 214, n. 33, *see also, Touche Ross & Co. v. Redington*, ___ U.S. ___ (1979), 61 L. Ed. 2d 82, 97 (1979); *SEC v. Blatt, supra* at 1333.

Furthermore, proof of scienter should also be made a requirement in Commission injunctive actions brought under Section 17(a). The "courts have endeavored to treat the 1933 and 1934 Acts *in pari materia* and to construe them as a single comprehensive scheme of regulation." *Globus v. Law Research Service, Inc.*, 418 F. 2d 1276, 1286 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). It is unlikely that Congress (the same Congress that passed the Securities Act of 1933, also approved the Securities Exchange Act of 1934) intended to have different elements of proof for injunctive actions brought under Section 10(b) or Section 17(a). Both sections deal with the same subject matter, viz., anti-fraud measures relating to the offer and sale, and purchase of securities.

ARGUMENT

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, n.12 (1976), this Court held that proof of scienter[8] is a necessary element in a private damage action under Section 10(b) of the Securities and Exchange Act of 1934, and Rule 10b-5. This Court also stated:

> "since this case concerns an action for damages, we also need not consider the question whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5. *Cf. SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 11 L. Ed. 2d 237, 84 S. Ct. 275 (1963)."

Mr. Justice Blackmun in dissent, with whom Mr. Justice Brennan joined, stated, ". . . for surely the question whether negligent conduct violates the Rule should not depend upon the plaintiff's identity. If negligence is a violation factor when the SEC sues, it must be a violation factor when a private party sues." (425 U.S. at 217-218).

The issue before this Court, therefore, is whether the reasoning on which the *Hochfelder* decision is based requires the conclusion that the Commission must allege and prove scienter in actions for injunctive relief for violations of the anti-fraud provisions of the 1933 and 1934 Acts.

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8. In *Hochfelder*, 420 U.S. at 194, n. 12, this Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." Since, however, the court of appeals did not address themselves to whether Aaron's conduct would support a finding of scienter, the question of what constitutes scienter is not before this Court.

I.

PROOF OF SCIENTER IS A NECESSARY ELEMENT IN COMMISSION ACTIONS FOR INJUNCTIVE RELIEF UNDER SECTION 10(b) OF THE SECURITIES AND EXCHANGE ACT OF 1934 AND RULE 10b-5 PROMULGATED THEREUNDER, AND UNDER SECTION 17(a) OF THE SECURITIES ACT OF 1933.

A. The analysis by this Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), forces the conclusion that scienter is an essential element of a commission injunctive action under Section 10(b).

This Court in *Hochfelder* based its conclusion primarily on the statutory text of Section 10(b), the legislative history, its setting within the statutory scheme of the 1933 and 1934 Acts, and the administrative history of Rule 10b-5. Construing the language of Section 10(b),[9] this Court determined that the "words manipulative or deceptive" used in conjunction with device or contrivance strongly suggest that §10(b) was intended to proscribe knowing or intentional misconduct (425 U.S. at

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9. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. §78j provides in relevant part:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means for instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

197).[10] Moreover, this Court stressed as "especially significant" the use of the word "manipulation." "It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." (425 U.S. at 199).

In examining the legislative history of Section 10(b), this Court found relevant portions of the legislative history to "support (its) conclusion that §10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone." (425 U.S. at 201-206).[11]

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10. "*Ernst & Ernst v. Hochfelder*, at 197, makes clear the starting point in every case involving construction of a statute is the language itself." *Transamerica Mortgage Advisors, Inc., et al. v. Lewis*, ___ U.S. ___ (Nov. 13, 1979), 48 LW 4001, *Touche Ross & Co. v. Redington*, ___ U.S. ___ (1979), 61 L. Ed. 2d 82, 91.

11. This Court quoted at 425 U.S. at 202 what it regarded as the "most relevant exposition of the provision that was to become §10(b)."

Subsection (c) [§9(c) of HR 7852 — later §10(b)] says, "Thou shalt not devise any other cunning devices."

> "Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices" Hearings on HR 7852 and HR 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934).

> "This brief explanation of §10(b) by a spokesman for its drafters is significant. The section was described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.' It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions."

Furthermore, this Court also noted that the administrative history of Rule 10b-5 "(makes) clear that when the Commission adopted the Rule, it was intended to apply only to activities that involved scienter" 425 U.S. at 212. Finally, this Court held that "its scope (Rule 10b-5) cannot exceed the power granted the Commission by Congress under §10(b), 425 U.S. at 214. Analysis of the statute had already revealed that Congress intended to proscribe only intentional misconduct.

Accordingly, this Court's interpretation of the language and history of Section 10(b) compels a requirement of scienter in Commission enforcement proceedings as well. Since private damage actions and enforcement proceedings both must rely upon the same language and history of Section 10(b), this Court's construction in *Hochfelder* warrants an identical standard for the two types of actions. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 217-218 (1976) (Blackmun, J., dissenting). In *Securities and Exchange Commission v. Blatt*, 583 F. 2d 1325, 1333 (5th Cir. 1978), the court of appeals stated:

> "*Hochfelder's* analysis applies forcefully to the issue sub judice. If the language and history of §10(b) are dispositive in private damage actions, the same must also be true in SEC injunctive actions. Both types of actions are creatures of the same statute, the language and legislative history are, of course, the same."

Accord SEC v. Willis, ___ F. Supp. ___ (D.D.C. Dec. 14, 1978).

In addition, in *Blatt*, the court of appeals also found that the legislative history relied upon by this Court in *Hochfelder* applies with even greater force to Commission enforcement actions. The court of appeals stated at 583 F. 2d 1333, n. 21:

> "Perhaps the language and history of §10(b) permit a stronger inference that Congress

> intended to require scienter in SEC actions than in private damage suits. The Supreme Court has determined that Congress did not contemplate private actions under §10(b). *Hochfelder*, 425 U.S. at 196, 96 S. Ct. 1375. Therefore, it follows logically that the scienter requirement implicit in the statute must have been intended for SEC proceedings. *See Note, Scienter and Injunctive Relief Under Rule 10b-5, 11 Ga. L. Rev. 879, 891 (1977).*"

Although the Second Circuit Court of Appeals strongly urged that policy considerations present in Commission injunctive actions provide a sufficient means to distinguish private actions for damages, this Court noted "as we find the language and history of §10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of "policy" set forth by the parties, that may have influenced the lawmakers in their formulation of the statute." 425 U.S. 214, n. 33. *See also, Touche Ross & Co. v. Redington,* ___ U.S. ___ (1979), 61 L. Ed. 2d 82, 97 (1979) ("Only last term, we emphasized that generalized references to the remedial purposes of the 1934 Act will not justify reading a provision more broadly than its language and the statutory scheme reasonably permit."); *Securities and Exchange Commission v. Blatt,* 583 F. 2d 1325, 1333 (5th Cir. 1978) ("Despite the appeal of such policy arguments, the language of the statute must control when sufficiently clear in its context. In our judgment, the language of §10(b) controls.")[12]

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12. The policy arguments relied upon by the Second Circuit Court of Appeals, are perhaps best summarized in a quote from *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 854-855 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969):

> "In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the

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> investing public . . . for policy reasons which seem perfectly consistent with the broad Congressional design.
>
> Absent any clear indication of a legislative intention to require a showing of specific fraudulent intent . . . the securities laws should be interpreted as an expansion of the common law both to effectuate the broad remedial design of Congress . . . and to insure uniformity of enforcement. . . . Moreover . . . the implementation of a standard of conduct that encompasses negligence comports with the administrative and the legislative purposes underlying the Rule. . . . This requirement, whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule." (Footnotes and citations omitted.)

This "effect analysis" approach was rejected by this Court in *Hochfelder*, 425 U.S. 198-199:

> "(T)he commission cites the overall congressional purpose in the 1933 and 1934 Acts to protect investors against false and deceptive practices that might injure them. . . . The Commission then reasons that since the 'effect' upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning."

Moreover, the argument that an injunction does not impose the serious burdens imposed by money judgments (*see e.g., SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 193 (1963); *Arthur Lipper Corp. v. SEC*, 547 F. 2d 171, 180, n. 6 (2d Cir. 1976) is also inapplicable.

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Further, any reliance on *SEC v. Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180 (1963) is misplaced. The issue in *Capital Gains* was "whether under the Investment Advisers Act of 1940 the Securities and Exchange Commission may obtain an injunction compelling a registered investment adviser to disclose to his clients a practice of purchasing shares of a security for his own account shortly before recommending that security for long-term investment and then immediately selling the shares at a profit upon the rise in the market price following the recommendation." The action was brought alleging violations of Section 206(2) of the Investment Advisers Act of 1940, which prohibits any practice which operates as a "fraud or deceit" upon any client.

In *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) n. 11, this Court noted that "although *Capital Gains* involved a federal securities statute, the court's references to fraud in the

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For example, an injunction can result in the suspension or revocation of a broker-dealer's registration, or can constitute grounds for barring any person from associating with a broker-dealer, under §15(b)4(c) of the 1934 Act, 15 U.S.C. §78o(b)(4)(c) (1970). Similar penalties can arise for investment advisers under §203(e) of the Investment Advisers Act, 15 U.S.C. §80(b)-3(e) (1970). In like manner, §9(a)(a) of the Investment Company Act, 15 U.S.C. §80(a)-9(a)(2) (1970), prohibits anyone subject to an injunction from serving as an employee, officer, director, member of an advisory board, investment adviser or depositor of a registered investment company. The granting of an injunction can also constitute grounds for barring any attorney, accountant or other expert from practicing before the SEC, under SEC Rule 2(e)(3)(i), 17 C.F.R. §201.2(e)(3)(i) (1976). Finally, an issuer of securities subject to injunction may be deprived of a Regulation A exemption under Rule 252(c)(4) of Regulation A, 17 C.F.R. §230.252(c)(4) (1976).

In addition, the consequences of an injunction, such as loss of business, injury to reputation, and potential disbarment from practice before the Commission, make the injunction as significant to the professional as the imposition of money damages would be to anyone else. *Accord*, Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U. L. Rev. 769, 787-788 (1976).

'equitable' sense of the term were premised on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers."[13]

Thus, the statutory text and legislative history of Section 206 of the Investment Advisers Act are dissimilar to that of Section 10(b) of the 1934 Act, and are of no significance in determining the elements for a government enforcement action under Section 10(b).[14]

In sum, the analysis by this Court in *Hochfelder* warrants that identical standards be applied in both damage actions and enforcement actions.

B. Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities and Exchange Act of 1934 should be construed *in pari materia*.

The court of appeals also found that Aaron violated Section 17(a) of the Securities Act,[15] concluding that scienter is not an

13. In *Capital Gains*, 376 U.S. 190, n. 39, however, Mr. Justice Goldberg specifically found that the defendant's failure to disclose was purposeful, and that they intended that action be taken in reliance on the claimed disinterestedness in the securities transactions they recommended.

14. For an extensive criticism of *Capital Gains*, *see Berner & Franklin, supra*, at 781-787.

15. Section 17(a) of the Securities Act provides:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud, or

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element in a Commission injunctive action under that section. The statutory language of Section 17(a)(2) and possibly that of Section 17(a)(3) indicates that those subsections were intended to proscribe conduct not involving scienter. Moreover, the legislative history of Section 17(a) apparently implies that scienter was not intended as an element of that section. Petitioner contends, however, that this Court's holding in *Hochfelder* requires a finding of scienter for government enforcement actions under Section 10(b) and, therefore, under "settled principles of statutory construction", the same standards should apply to injunctive actions brought by the Commission under Section 17(a). *See Erlenbaugh v. United States,* 409 U.S. 239, 243 (1972); the two Acts are *in pari materia* and should be construed together as one body of law. *Globus v. Law Research Service, Inc.,* 418 F. 2d 1276, 1286 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970). Prior to discussing the principle of *in pari materia* in this context, petitioner will review the statutory language and legislative history of Section 17(a).

The language of Section 17(a)(1) clearly requires some showing of scienter. In *Steadman v. SEC,* ____ F. 2d ____ (5th Cir. October 4, 1979), the Fifth Circuit Court of Appeals addressed themselves to the meaning of Section 17(a)(1):

> "We come now to subsection 17(a)(1). This clause contains the word 'device' that the Supreme

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> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

> Court in *Hochfelder* found to be suggestive of intentional conduct when read together with 'manipulative' and 'deceptive'. 425 U.S. at 197, 96 S. Ct. at 1383. The latter two words do not appear in subsection 17(a)(1), but the three words of that section — device, scheme, and artifice — must each be read in conjunction with the words 'to defraud'. *The resulting phrases — device to defraud, scheme to defraud, artifice to defraud — carry strong implications of intentional conduct. We do not think Congress would have used such language if it meant to reach merely negligent actions.* The use of the term 'employ' further supports our reading of the section. See *Hochfelder,* 425 U.S. at 199, n. 20, 96 S. Ct. at 1384." (Emphasis added.)

See also, Sanders v. John Nuveen & Co., 554 F. 2d 790, 795 (7th Cir. 1977); *Trussell v. United Underwriters, Ltd.,* 288 F. Supp. 757, 770 (D. Colo. 1964); 3 L. Loss, *Securities Regulation,* 1441-1442 (2d Ed. 1961).

Subsection (2) of 17(a), however, makes no reference to fraud, deceit or schemes. This language, arguably, does not require scienter. The Second Circuit Court of Appeals in *SEC v. Coven,* 581 F.2d 1020, 1026 (1978), *cert. denied,* ____ U.S. ____ (1979), and the Fifth Circuit Court of Appeals in *Steadman v. SEC, supra,* have concluded that scienter is not required in a Commission injunctive action under subsection (2). Professor Loss has also stated: "There is nothing on the face of clause (2) itself that smacks of scienter or intent to defraud at all."[16] 6 L. Loss, *Securities Regulation,* 3552-3553 (2d Ed. Supp. 1969).

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16. Indeed this Court in *Hochfelder,* 425 U.S. at 212 stated:

> "Viewed in isolation the language of subsection (b), and arguably that of subsection (c), could be read as proscribing, respectively, any type of material misstatement or omission,

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Moreover, prior analyses of Section 17(a)(3) have resulted in conflicting interpretations. This Court in *Hochfelder*, 425 U.S. at 212, acknowledged that the language of Rule 10b-5(c) "could be read as proscribing, . . . any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not." The Second Circuit Court of Appeals, in *SEC v. Coven, supra*, and the Fifth Circuit Court of Appeals in *Steadman v. SEC*, *supra*, both have concluded that "the clear impact of the critical phrase in subsection (3), 'operates as a fraud', is to focus attention on the effect of potentially misleading conduct on the public, not on the culpability of the person responsible." 581 F. 2d at 1026. Conversely, Professor Loss has argued that the use of the terms fraud and deceit in subsection (3) suggests that a scienter standard is contained in subsection (3),[17] 3 L. Loss, *Securities Regulation*, 1441-1442 (2d Ed. 1961); 6 L. Loss, *Securities Regulation*, 3552 (2d Ed. Supp. 1969).

In addition, analysis of the legislative history of §17 apparently indicates that Congress did not intend that scienter should be an element of a government enforcement action under Section 17(a). That history has been canvassed in *SEC v. Coven*, 581 F. 2d at 1027; *see also*, Note, *The Scienter Requirement in S.E.C. Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfelder*, 77 Colum. L. Rev. 419, 429-432 (1977);

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and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not."

Subsections (b) and (c) of Rule 10b-5 are almost identical with subsections (2) and (3) of Section 17(a) respectively.

17. *Webster New Twentieth Century Dictionary Unabridged*, Second Edition, 1970, defines fraud as:

"(a) deceit, trickery, cheating;

(b) in law, intentional deception to cause a person to give up property or some lawful right."

Douglas & Bates, *The Federal Securities Act of 1933*, 43 Yale L. J. 171, 181-182 (1933) ("Section 17 makes unlawful all schemes to defraud. Likewise it makes unlawful all schemes to defraud. Likewise it makes unlawful even innocent acts to obtain money or property, by means of untrue statements of material facts or omissions to state material facts").

Petitioner contends, however, that the three subsections of 17(a) should be construed together with Section 10(b) to require proof of scienter in government enforcement actions. It is a well-settled principle of statutory construction that statutes should be reconciled where possible. *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 155 (1976), quoting *Morton v. Mancari*, 417 U.S. 535, 550 (1972). Section 10(b) and Rule 10b-5 promulgated thereunder, and Section 17(a) of the Securities Act of 1933 are general anti-fraud provisions obviously aimed at the same general evils in the field of securities regulation. Section 17(a) refers to fraud or misrepresentation "in the offer or sale of any securities". Section 10(b) and Rule 10b-5 applies to fraud in the *purchase* or sale of any security. In fact "Rule 10b-5 merely borrows the language of §17(a) of the Securities Act, except for the reference in clause (2) to obtaining any money or property by means of an untrue statement or half-truth". 3 L. Loss, *supra* at 1426-1427 (2d Ed. 1961).

Thus, if scienter is to be required in Commission actions for injunctive relief under Section 10(b) and Rule 10b-5, it should also be required in Commission actions for injunctive relief pursuant to Section 17(a). It must be remembered that the very purpose of adopting Rule 10b-5 was to eliminate the differences in treatment of buyer and seller transactions. To permit any distinction between the Acts would create an anomaly. Therefore, to avoid such inconsistencies, these Acts have been treated *in pari materia* and construed as a single comprehensive scheme of regulation. *Globus v. Law Research Service, Inc.*, 418 F. 2d 1276, 1286 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). *See also, Golub v. PPD Corp.*, 576 F. 2d 759, 764 (8th

Cir. 1978); *Ballard & Cordell Corp. v. Zoller & Danneberg*, 544 F. 2d 1059, 1066 (10th Cir. 1976); *Axelrod & Co. v. Kondich, Victor & Neufield*, 451 F. 2d 838, 843 (2d Cir. 1971).

In *Erlenbaugh v. United States*, 409 U.S. 239, 243-244 (1972), this Court construed the rule of *in pari materia* by stating:

> "*The rule of in pari materia* like any canon of statutory construction is a reflection of practical experience in the interpretation of statutes: a legislative body generally uses a particular word with a consistent meaning in a given context. Thus, for example, a 'later act can . . . be regarded as a legislative interpretation of (an) earlier act . . . in the sense that it aids in ascertaining the meaning of the words as used in their contemporary setting,' and 'is therefore entitled to great weight in resolving any ambiguities and doubts'. *United States v. Stewart, supra*, at 64-65. See also, e.g., *Hunter v. Erickson*, 393 U.S. 385, 388 (1969); *United States v. Freeman, supra*, at 565. The rule is but a logical extension of the principle that individual sections of a single statute should be construed together, for it necessarily assumes that whenever Congress passes a new statute, it acts aware of all previous statutes on the same subject, cf. *Allen v. Grand Central Aircraft Co.*, 347 U.S. 535, 541-552 (1954). Given this underlying assumption, the rule's application certainly makes the most sense when the statutes were enacted by the same legislative body at the same time."[18]

18. "To be *in pari materia*, statutes need not have been enacted simultaneously or refer to one another. However, application of the rule that statutes *in pari materia* should be construed together is most justified, and light from that source has the greatest probative force, in the case of statutes

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That Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act are *in pari materia* is manifest. Both deal with the same subject matter, viz., anti-fraud measures relating to the offer and sale, and purchase of securities. Moreover, the same Congress which passed the Securities Act in 1933 approved the Securities Exchange Act in 1934, *Tchereprin v. Knight*, 389 U.S. 332, 342 (1967). In addition, Professor Loss has stated:

> "There is abundant evidence, even apart from the 1934 amendments of the 1933 act, *that the two statutes are in pari materia — indeed, as closely related as two nominally separate statutes could be:*
>
> (1) President Roosevelt, in his message recommending a Securities Act, stated, as he specifically recalled in his message of the next year recommending an act to regulate the stock exchanges:
>
> This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all

(Cont'd)

relating to the same subject matter that were passed at the same session of the legislature, especially if they were passed or approved or take effect on the same day, or in the case where the later of two or more statutes relating to the same subject matter refers to the earlier. In these situations the probability that acts relating to the same subject matter were actuated by the same policy is very high, for in the first three situations mentioned they were enacted by the same men and in the last were declared to be within the knowledge of the legislature at the same time. But in construing an ambiguous enactment it is held proper to consider not only acts passed at the same session of the legislature or other acts to which the act in question refers, but also acts passed at prior and subsequent sessions to which the act does not refer. However, if a subsequent action is in irreconcilable conflict with the act under consideration, the subsequent act must prevail." *Sutherland, Statutory Construction*, §51.03.

> property dealt in on exchanges . . ." (Citations omitted, emphasis added.) 6 L. Loss, *Securities Regulation*, 3915-3916 (2d Ed. Supp. 1969)

Accordingly, to eliminate any anomaly between the elements for an injunctive action under Section 17(a) and Section 10(b), proof of scienter should be made a requirement in actions brought under either section. The "courts have endeavored to treat the 33 and 34 Acts *in pari materia* and to construe them as a single comprehensive scheme of regulation." *Vacca v. Intra Management Corp.*, 415 F. Supp. 248, 250 (E.D. Penn.) quoting, *Globus v. Law Research Service, Inc., supra.* In *Vacca*, that district court held that "While the Supreme Court left open the question of whether scienter is a necessary element in an action for injunctive relief under those provisions, 96 S. Ct. at 1381 n. 12, we believe that the *Ernst & Ernst v. Hochfelder* holding applies equally to both equitable actions for rescission and actions at law for money damages." (Citations omitted.) *See also, Malik v. Universal Resources Corp.*, 425 F. Supp. 350 (D. Cal. 1976) (Scienter is a required element of proof under §17(a) in a private damage action).

In sum, Section 17(a) of the 1933 Act should be read in harmony with Section 10(b) of the 1934 Act to require a showing of scienter before an injunction will issue.

CONCLUSION

The judgment of the court of appeals should be reversed, and the case be remanded for further proceedings to decide whether Aaron's conduct would support a finding of scienter.

Respectfully submitted,

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Supreme Court, U. S.
FILED
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MICHAEL RODAK, JR., CLERK

No. 79-66

In the Supreme Court of the United States

OCTOBER TERM, 1979

PETER E. AARON, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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In the Supreme Court of the United States

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No. 79-66

PETER E. AARON, PETITIONER

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SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-29a) is reported at 605 F.2d 612.[1] The opinion of the district court (Pet. App. 30a-50a) is unreported.

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[1] The opinion of the court of appeals, as officially reported, contains a number of substantive corrections that do not appear in the opinion attached to the petition for a writ of certiorari.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1979. On June 11, 1979, Mr. Justice Marshall extended the time in which to file a petition for a writ of certiorari to and including July 10, 1979. The petition for a writ of certiorari was filed on July 10, 1979, and was granted on October 15, 1979. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the Securities and Exchange Commission must prove scienter in an enforcement proceeding brought under Section 20(b) of the Securities Act of 1933, 15 U.S.C. 77t(b), to enjoin acts and practices in violation of Section 17(a) of the Act, 15 U.S.C. 77q(a).

2. Whether the Securities and Exchange Commission must prove scienter in an enforcement proceeding brought under Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(d), to enjoin acts and practices in violation of Section 10(b) of the Act, 15 U.S.C. 78j(b), and Commission Rule 10b-5, 17 C.F.R. 240.10b-5.

STATUTES AND RULE INVOLVED

1. Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

2. Section 20(b) of the Securities Act of 1933, 15 U.S.C. 77t(b), provides in pertinent part:

> Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this subchapter, or of any rule or regulation prescribed under authority thereof, it may in its discretion bring an action in any district court of the United States or United States court of any Territory, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond * * *.

3. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. 78j, provides in pertinent part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

4. Section 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78u(d), provides in pertinent part:

Wherever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provisions of this chapter, [or] the rules or regulations thereunder, * * * it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

5. SEC Rule 10b-5, 17 C.F.R. 240.10b-5, provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

STATEMENT

1. In February 1976, the Securities and Exchange Commission filed a complaint in the United States District Court for the Southern District of New York against eight defendants, including petitioner,[2] alleging violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), Section 10(b) of the Securities Exchange

[2] Each defendant except petitioner consented to the entry of a permanent injunction (Pet. App. 31a).

Act of 1934, 15 U.S.C. 78j(b), and SEC Rule 10b-5, 17 C.F.R. 240.10b-5, in connection with the offer and sale of common stock of Lawn-A-Mat Chemical & Equipment Corp. ("Lawn-A-Mat") (A. 15a-19a).[3] The complaint alleged that petitioner violated and aided and abetted violations of the antifraud provisions because he knew or should have known that certain employees of a broker-dealer firm who were under his supervision were making materially false and misleading representations in the offer and sale of Lawn-A-Mat stock, but failed to take steps to terminate the fraudulent practices (*id.* at 16a-18a).

During the period in question, petitioner was employed by E. L. Aaron & Co., Inc., a registered broker-dealer firm with its principal office in New York City. Petitioner had been employed by the firm for 15 years and served in a managerial and supervisory capacity (Pet. App. 33a). Petitioner maintained the due diligence files for securities in which the firm

[3] The complaint also charged petitioner and three other defendants with violations of the registration provisions of Section 5(a) and (c) of the Securities Act of 1933, 15 U.S.C. 77e(a) and (c) (A. 13a-15a). The district court found that petitioner had violated the registration provisions and enjoined him from future violations (Pet. App. 40a-44a). The court of appeals affirmed this disposition, noting that petitioner had arranged a sham transaction in order to create the appearance of an exemption from the registration requirements of the Act (*id.* at 10a-13a, 21a). Petitioner has not questioned the judgment of the district court insofar as it enjoins him from future violations of the registration provisions.

made a market.[4] He also supervised the firm's employees, received and answered complaints about their activities, and participated in the process of hiring them. As a supervisor of the firm's registered representatives, petitioner conducted sales meetings and discussed sales techniques. He also monitored the trading activities of the registered representatives, advising them of their monthly transaction figures and informing them when clients were late in making payment (*ibid.*).

In November 1974, Aaron & Co. opened a branch office in Roslyn Heights, New York. Norman Schreiber, a registered representative of Aaron & Co., was appointed branch manager of the new office. Donald Jacobson, another registered representative, served as Schreiber's assistant. From November 1974 through September 1975, Schreiber and Jacobson contacted stockholders of Lawn-A-Mat and its franchise-dealers by telephone and by mail to solicit orders for Lawn-A-Mat common stock. In the course of this promotion, they repeatedly made false and misleading statements to prospective investors. Among other material misrepresentations, they stated that Lawn-A-Mat was planning or was in the process of manufacturing a new type of small car and tractor. They also told investors that the car would be marketed in six weeks. In fact, Lawn-A-Mat had no plans to manufacture a car or tractor (Pet. App. 35a).

[4] Those files contained current information on the business activities and financial condition of various issuer companies, including Lawn-A-Mat (Tr. 315-316, 322, 329-330).

Schreiber and Jacobson also made projections of substantial increases in the price of Lawn-A-Mat stock and in the sales and earnings of the company. In fact, the company was experiencing losses during the period in question and Schreiber and Jacobson had no basis for making optimistic financial predictions (*ibid.*).

Some of the prospective investors contacted by Schreiber and Jacobson complained to Lawn-A-Mat about these statements. As a result, Fernando Erazo, a Lawn-A-Mat officer, and Milton Kean, an attorney representing Lawn-A-Mat, informed Schreiber and Jacobson that their statements were false and asked them to cease making the false statements. Nonetheless, Jacobson and Schreiber continued to make such assertions while soliciting securities orders (Pet. App. 34a-36a).

When the warnings given to Schreiber and Jacobson proved to be ineffective, Kean complained to petitioner on two occasions, warning him that Schreiber and Jacobson were continuing to make false and misleading statements in connection with their selling campaign (Pet. App. 35a-36a). The due diligence files in petitioner's custody at the time also confirmed that there was no factual basis for the representations that Schreiber and Jacobson were making to prospective investors (*id.* at 36a, 38a). Petitioner mentioned Kean's complaint to Jacobson, but, notwithstanding his supervisory responsibilities under the federal securities laws (see page 43, *infra*) and his assurance to Kean that he would stop the misrepresentations,

petitioner permitted Schreiber and Jacobson to continue their fraudulent behavior (Pet. App. 38a-39a).

2. Following a three-day trial, the district court concluded that petitioner violated Section 17(a), Section 10(b), and Rule 10b-5 by failing to take steps to terminate the fraudulent practices of Jacobson and Schreiber after those practices had been brought to his attention (Pet. App. 39a-40a). The district court found that petitioner "was specifically responsible for supervising the registered representatives" of his firm (Pet. App. 39a; *id.* at 32a-33a)[5] and that petitioner therefore "must be held responsible along with Schreiber and Jacobson for the fraudulent representations that were made" (*ibid.*). Accordingly, the court enjoined him from future violations of Section 17(a), Section 10(b), and Rule 10b-5 (Pet. App. 31a, 45a).

The court of appeals affirmed (Pet. App. 21a). Addressing Section 10(b) and Rule 10b-5, the court rejected petitioner's contention that the Commission must establish scienter to obtain an injunction against future violations of these provisions. The court held that deceptive practices resulting from a defendant's negligence are a sufficient predicate for injunctive relief authorized by Section 21(d) of the Securities Exchange Act. The court of appeals noted that this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 194 n.12 (1976), which held that scienter is a necessary element of a private damage action

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[5] Petitioner does not challenge this finding.

under Section 10(b) and Rule 10b-5, had "explicitly left open the question whether scienter would be required in * * * injunction actions" (Pet. App. 13a). In declining to adopt a scienter requirement for Commission injunctive proceedings, the court of appeals analyzed the language of Section 10(b), the legislative history of the Securities Exchange Act, the relationship between Section 10(b) and the express private remedy provisions of the securities laws, the effect that a scienter standard would have on the enforcement scheme fashioned by Congress, and the "compelling distinctions between private damage actions and government injunction actions" (Pet. App. 15a, 17a-18a). The court observed that its prior decisions had required scienter in private damage actions even before *Hochfelder*, but uniformly had held "that the language and history of [Section 10(b)] did not require a showing of scienter in an injunction enforcement action brought by the Commission" (*id.* at 15a). Quoting its decision in *SEC* v. *Coven*, 581 F.2d 1020, 1027-1028 (2d Cir. 1978), cert. denied, 440 U.S. 950 (1979), the court remarked that "[t]he essential nature of an SEC enforcement action is equitable and prophylactic; its primary purpose is to protect the public against harm, not to punish the offender" (Pet. App. 16a). The court also explained that a negligence standard in injunctive proceedings is consistent with the statutory enforcement scheme because, unlike the situation in *Hochfelder*, no provisions of the federal securities laws would be nullified or superseded by permitting the Commission to

obtain injunctions based on proof of negligent deceptive practices (*id.* at 18a-19a).[6]

The court of appeals also rejected a scienter requirement for Commission injunctive proceedings brought under Section 17(a), relying on its prior decision in *SEC* v. *Coven*, *supra* (Pet. App. 19a). In *Coven*, the court of appeals had observed that Section 17(a) does not contain language requiring proof of scienter. The *Coven* opinion also explained that the legislative history of Section 17(a) shows that Congress had considered a scienter requirement but "opted for liability without willfulness, intent to defraud, or the like, in enacting § 17(a)." 581 F.2d at 1027-1028.[7]

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[6] In *Hochfelder*, this Court pointed out that the statutory provisions expressly allowing private recovery for negligent conduct, Sections 11, 12(2), and 15 of the Securities Act of 1933, 15 U.S.C. 77k, 77*l*(2), and 77*o*, are "subject to significant procedural restrictions not applicable under § 10(b)." 425 U.S. at 208-209. An extension of private damage remedies under Section 10(b) to cases of negligent wrongdoing, the Court concluded, would "nullify the effectiveness of the carefully drawn procedural restrictions on these express actions." 425 U.S. at 210.

[7] Because it found proof of scienter to be unnecessary in this proceeding, the court of appeals declined to "reach the question whether [petitioner's] conduct would support a finding of scienter * * *" (Pet. App. 13a). The district court had found that petitioner's misconduct was "sufficient to establish his scienter" and noted that petitioner's conduct would violate the antifraud provisions "under either a negligence or a scienter theory of liability" (*id.* at 40a).

SUMMARY OF ARGUMENT

I.

In determining Congress' intent in enacting antifraud provisions forbidding deception in securities transactions and in conferring authority on the Commission to seek injunctive relief against violations of those provisions, it is appropriate to consider the historical approach of courts of equity to fraudulent practices. In authorizing equitable relief against fraudulent practices under Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act, Congress did not legislate on a blank slate. At the time that Congress enacted the federal securities laws it was well established that, while intent to deceive was generally required to secure money damages for fraud in an action at law, relief against fraud could be had in equity without proof of scienter. As this Court noted in *Smith* v. *Richards*, 38 U.S. (13 Pet.) 26, 36 (1839): "[i]f * * * a man * * * make a false representation, whether knowingly or not, by means of which he puts the party bargaining under a mistake upon the terms of bargain, it is a fraud, and relievable in equity."

Prior to the federal securities laws, various states enacted securities statutes providing governmental authority to seek injunctions against securities fraud. For example, under New York's Martin Act (N.Y. Gen. Bus. Law §§ 352-353 (Consol. 1921)), which served as a model for Section 17(a) of the Securities Act and for the scheme of injunctive remedies pro-

vided under the Securities Exchange Act, it was well established that the New York Attorney General could obtain an injunction against fraud without proof of scienter.

This tradition of broad equitable jurisdiction over deceptive practices underlies the Court's decision in *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the decision cited by this Court in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 194 n.12 (1976), in reserving judgment on the question whether scienter must be proven in injunctive proceedings brought under Section 10(b) of the Securities Exchange Act. *Capital Gains*, which provides the rule of statutory interpretation that is controlling in the present case, was a suit by the Commission for injunctive relief to restrain deceptive practices forbidden by the general antifraud provision of the Investment Advisers Act. This Court concluded that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages." 375 U.S. at 193. The Court pointed out that intention to defraud or misrepresent is not a necessary element of fraud in equity and added that it should not be assumed that Congress, in enacting the federal securities laws, was unaware of this doctrine or meant to depart from it. *Id.* at 192-195.

The similarities between the present case and *Capital Gains* are apparent. Both involve remedial statutes granting broad equitable jurisdiction to the district courts to issue injunctions, and both involve

general antifraud provisions intended to protect investors against deception. Moreover, both cases involve statutes enacted at a time when the distinction between fraud at law and in equity was well established both in general jurisprudence and in the field of securities regulation. These similarities support the conclusion of the court of appeals that injunctive relief, in contrast to the legal remedy of money damages, may be had without proof of scienter or fraudulent intent.

II.

The language of Section 17(a)(2) and (3) of the Securities Act, 15 U.S.C. 77q(a)(2) and (3), confirms that scienter is not an element in an injunctive proceeding brought by the Commission under those provisions. Section 17(a)(2) forbids any person to obtain money or property in the offer or sale of a security "by means of any untrue statement of a material fact or any omission to state a material fact." Section 17(a)(3) forbids any person to engage in "any transaction, practice, or course of business which operates or would operate as a fraud or deceit" in the offer or sale of a security. Although petitioner argues that a scienter requirement should be read into these terms, "[n]othing on the face of the statute supports this reading of it." *United States* v. *Naftalin*, No. 78-561 (May 21, 1979), slip op. 5. To the contrary, this Court's holding in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, and the views expressed in *Ernst & Ernst* v. *Hochfelder*, *supra*, confirm that the language used by Congress in Section

17(a)(3) does not require proof of an intent to deceive. Moreover, as the Court noted in *Hochfelder* with respect to the virtually identical language appearing in Rule 10b-5(b), Section 17(a)(2) contains an unqualified prohibition against misstatements or omissions used to obtain money from other persons in securities transactions, without any suggestion of a scienter requirement. In sum, engrafting an exception onto these general antifraud provisions to immunize negligent misrepresentations "would create a loophole in the statute that Congress simply did not intend to create." *United States* v. *Naftalin*, *supra*, slip op. 8.

The legislative history confirms that Congress intended to dispense with a scienter requirement in Commission injunctive proceedings brought under Section 17(a). Early drafts of Section 17(a) included the requirement that the forbidden deceptive conduct be undertaken "willfully" and "with the intent to defraud." Those terms, which were inserted to require proof of scienter, were subsequently stricken by the Conference Committee before Section 17(a) was enacted. Under the resulting statutory scheme, "willful" behavior must be proven in a criminal prosecution brought to enforce Section 17(a). See Section 24 of the Securities Act, 15 U.S.C. 77x. But no such requirement is imposed by the statutory provision authorizing injunctive relief in an equitable proceeding brought under Section 17(a). See Section 20(b) of the Act, 15 U.S.C. 77t(b).

III.

The general prohibition of fraudulent practices contained in Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), as implemented by SEC Rule 10b-5, 17 C.F.R. 240.10b-5, extends to any "manipulative or deceptive device or contrivance" used in connection with a securities transaction. Neither this section nor the section of the Act authorizing injunctive relief (Section 21(d), 15 U.S.C. 78u(d)) contains an express scienter requirement. Although this Court held in *Ernst & Ernst* v. *Hochfelder*, *supra*, that Section 10(b) requires proof of scienter in a private action for damages, the Court expressly stated that it was not deciding whether scienter must be proven in the different context of an injunctive proceeding. 425 U.S. at 194 n.12. In limiting its holding in *Hochfelder*, the Court cited *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 193, which concluded that " '[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element' " in an action for equitable relief.

The court of appeals' conclusion that scienter is not required in an injunctive proceeding brought under Section 10(b) is supported not only by *Capital Gains* but also by the great majority of lower court decisions, handed down both before and after *Hochfelder*. Although *Hochfelder* found that the language of Section 10(b) is "sufficiently clear in its context" to warrant a scienter requirement (425 U.S. at 201), the meaning of the words used by Congress is altogether different in the context of an injunctive proceeding. It was well settled when Congress enacted Section 10(b) that equitable remedies were available in the case of deception without proof of scienter. Here, as in *Capital Gains*, it is not appropriate to "assume that Congress, in enacting legislation to prevent fraudulent practices * * *, was unaware of these developments in the common law of fraud." 375 U.S. at 195.

The Commission has consistently interpreted Section 10(b) to authorize injunctive relief against deceptive practices in securities transactions without proof of scienter. When Congress enacted significant amendments to the Securities Exchange Act in 1975 and 1977, it reviewed the Commission's interpretation and left it undisturbed. As noted in *Andrus* v. *Allard*, No. 78-740 (Nov. 27, 1979), slip op. 6, "it is particularly relevant that Congress has twice reviewed and amended the statute without rejecting the [agency's] view." See also *United States* v. *Rutherford*, No. 78-605 (June 18, 1979), slip op. 8-9 & n.10: "once an agency's statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned." This consideration provides additional support for the court of appeals' holding that Congress did not intend to require proof of scienter in an injunctive proceeding brought under Section 10(b).

IV.

The structure of the Securities Act of 1933 and the Securities Exchange Act of 1934 reinforces the conclusion that scienter is not required in injunctive proceedings brought under Sections 17(a) and 10(b). The concept of state of mind is treated with precision in the federal securities laws by use of words such as "knowing" and "willful." Thus, if Congress had wished to impose a state of mind requirement in Commission injunctive proceedings under the provisions involved in this case, it would have done so expressly. However, Sections 17(a) and 10(b), and the statutory provisions authorizing injunctive relief, contain no such requirement. These provisions stand in sharp contrast to the criminal penalty and certain administrative sanction provisions of the federal securities laws, which expressly require willfulness.

V.

Finally, it is appropriate to consider the practical consequences of the statutory interpretations advanced by the parties and their consistency with the underlying purposes of the securities laws. Adoption of petitioner's contention would immunize negligent deceptive practices from restraint and would thereby expose investors and the national economy to serious injury resulting from the dissemination of false financial information. Financial information disseminated in the national securities markets is used by individual investors, as well as by institutional investors such as bank trust departments, insurance

companies, and mutual funds, which rely on the accuracy of the information to make investment decisions involving large sums of money. As Judge Friendly observed in *United States* v. *Benjamin*, 328 F.2d 854, 863 (2d Cir.), cert. denied, 377 U.S. 953 (1964), "[i]n our complex society," false financial representations "can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." If, through carelessness, false information is conveyed, and the resulting deception threatens to be recurrent and injurious, the courts should not be powerless to protect the public through the prophylactic remedy of an injunction.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted following the stock market crash of 1929. Congress estimated in 1933 that investors had lost as much as 25 billion dollars as a result of false information about the securities that they purchased. The legislative history is replete with references to the grave harm to the nation caused by negligent misrepresentations in securities transactions. The statutes resulting from these concerns, as this Court repeatedly has stated, were intended to achieve a "high standard of business ethics * * * *in every facet of the securities industry.*" *United States* v. *Naftalin, supra*, slip op. 6 (emhasis in original). To deny the courts authority to order the "mild prophylactic" of injunctive relief (*SEC* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. at 193) to protect the public against

negligent dissemination of false information would defeat this important statutory purpose.

The Commission's enforcement program is critical to its ability to protect investors, and injunctions are the basic tools through which the Commission seeks compliance with the federal securities laws. Courts of equity traditionally have gone further to give relief when the public interest, rather than a matter of only private concern, is involved. Consistent with this tradition, federal courts should be permitted to enjoin deceptive conduct without proof of scienter. As the court of appeals correctly observed, "the increased effectiveness of government enforcement actions * * * outweigh[s] the danger of potential harm to those enjoined from violating the securities laws" (Pet. App. 15a).

ARGUMENT

PROOF OF SCIENTER IS NOT REQUIRED IN ENFORCEMENT PROCEEDINGS BROUGHT BY THE SECURITIES AND EXCHANGE COMMISSION TO ENJOIN FUTURE VIOLATIONS OF SECTION 17(a) OF THE SECURITIES ACT OF 1933 OR SECTION 10(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND COMMISSION RULE 10b-5

The question presented in this case is whether, in an enforcement action brought by the Securities and Exchange Commission, a federal district court, having found that a defendant has engaged in deceptive conduct in connection with a securities transaction and, unless enjoined, is likely to continue to engage in such conduct, may grant injunctive relief without proof that the defendant engaged in the deceptive

conduct with scienter. Resolution of this question—whether lack of due care, as well as scienter, may serve as a predicate for injunctive relief—will determine in no small degree the Commission's ability to protect the public from deceptive acts and practices. The two substantive statutory provisions here at issue, Sections 17(a) and 10(b), are the principal antifraud provisions of the Securities Act and the Securities Exchange Act, and Commission injunctive actions are the basic means through which these provisions are enforced. A technical and restrictive interpretation of these provisions, requiring proof of scienter and thus limiting the availability of injunctive relief when it is likely that deception will continue, would significantly weaken the important safeguards against fraud provided to public investors through Commission injunctive actions.

We contend that Congress authorized the district courts to grant the equitable remedy of an injunction in Commission actions without a showing of scienter. Petitioner disagrees, arguing that this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976), requires proof of scienter in injunctive proceedings as well as private damage actions. Yet *Hochfelder* expressly declined to address the question "whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5," citing *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). 425 U.S. at 194 n. 12. Moreover, *Hochfelder* did not consider the requirements

of Section 17(a) of the Securities Act of 1933, an independent basis for liability in the present case.

Hochfelder establishes, with respect to Section 10(b) and Rule 10b-5, that scienter must be proven in a judicially-implied private action for damages.[8] In the present case, the issue is whether scienter must be proven in an expressly authorized enforcement proceeding brought by the Securities and Exchange Commission to obtain injunctive relief, a remedy that is wholly equitable in nature. In this different context, the controlling precedent is *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, not *Hochfelder*. In *Capital Gains*, this Court concluded, in construing a parallel antifraud provision of the federal securities laws, that " '[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element.' " 375 U.S. at 193.

In the discussion below, we review the fundamental distinction between equitable proceedings brought to restrain fraudulent practices and private actions brought to obtain monetary relief. Against this background, we consider the meaning of the words used by Congress in Sections 17(a) and 10(b) and the teaching of the legislative history. We also consider the structure of the Securities Act of 1933 and the Securities Exchange Act of 1934, contrasting

[8] In this brief, "scienter" refers to intent to deceive or defraud, including knowing conduct and reckless disregard for the truth—conduct more culpable than negligence. See *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 194 n.12.

the language of Sections 17(a) and 10(b) and the statutory provisions authorizing injunctive relief with the language Congress repeatedly used to prescribe state of mind standards. Finally, we consider the practical consequences of a scienter requirement for Commission injunctive actions, in light of the purposes that Congress sought to achieve by this legislation. These considerations support the conclusion that, in the present circumstances as in *Capital Gains*, the Commission may enforce the securities laws to protect the public against deceptive practices in securities transactions without proof of intent to defraud.

I. Proof Of Scienter Historically Has Not Been Required To Obtain Equitable Relief Against Fraudulent Practices

In Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934, Congress enacted antifraud provisions to protect the public against misrepresentations and other deceptive practices in securities transactions; Congress authorized injunctive relief against such practices in Commission enforcement proceedings brought under Section 20(b) of the Securities Act, 15 U.S.C. 77t(b), and Section 21(d) of the Securities Exchange Act, 15 U.S.C. 78u(d). In construing these provisions, it is necessary to "begin with the language of the statute itself." *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, No. 77-1645 (Nov. 13, 1979), slip op. 4; *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 197. But as the Court reminded lower courts and litigants in *St. Paul Fire*

& Marine Ins. Co. v. *Barry*, 438 U.S. 531, 545-546 (1978), "words or phrases in a statute come 'freighted with the meaning imparted to them by the mischief to be remedied and by contemporaneous discussion. In such conditions history is a teacher that is not to be ignored'" (quoting *Duparquet Co.* v. *Evans*, 297 U.S. 216, 221 (1936) (Cardozo, J.)). Accord, *United Steelworkers of America, AFL-CIO-CLC* v. *Weber*, No. 78-432 (June 27, 1979), slip op. 5-6; *Agosto* v. *INS*, 436 U.S. 748, 754 (1978); *Standard Oil Co.* v. *United States*, 221 U.S. 1, 59 (1911).[9]

Placing the words used by Congress in historical perspective permits the reviewing court to ascertain the underlying statutory purpose—"courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." *SEC* v. *C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351 (1943). See also *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 849-851 (1975); *United States* v. *American Trucking Ass'ns*, 310 U.S. 534, 543 (1940).

1. In authorizing equitable relief against fraudulent practices in securities transactions, Congress did not legislate on a blank slate. The law governing

[9] See also *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 744-749 (1975).

equitable remedies against fraudulent practices was well established at the time Congress enacted the federal securities laws.

The requirement of scienter or fraudulent intent was the characteristic requirement in common law actions seeking monetary damages for fraud. The decision of the House of Lords in *Derry* v. *Peek*, 14 App. Cas. 337 (1889), reaffirmed the common law requirement of scienter in the securities fraud context, holding that a private damage action based on negligent misrepresentations would not lie.[10] But *Derry* itself confirmed that the rule in equity was different. *Id.* at 359. As this Court emphasized in *Smith* v. *Richards*, 38 U.S. (13 Pet.) 26, 36 (1839), "[i]f * * * a man, upon a treaty for any contract, make a false representation, whether knowingly or not, by means of which he puts the party bargaining under a mistake upon the terms of bargain, it is a fraud, and relievable in equity."

The rule in equity, providing relief for defrauded plaintiffs without proof of scienter, received general recognition prior to the enactment of the federal securities laws. See, *e.g.*, 1 J. Story, *Commentaries on Equity Jurisprudence* §§ 272, 368 (14th ed. W. Lyon 1918); II J. Pomeroy, *Equity Jurisprudence* § 885 (4th ed. 1918); H. Black, *Rescission of Contracts and Cancellation of Written Instruments* §§ 102, 106, 108 (2d ed. J. Lee 1929); 3 S. Williston, *The Law of Con-*

[10] See also 3 *Restatement of Torts* §§ 525-526 (1938); F. Harper, *The Law of Torts* § 76 (1933); XXVI C.J., *Fraud*, § 6 (1921).

tracts § 1500 (1920); G. Bower, *The Law of Actionable Misrepresentation* § 250 (2d ed. 1927); W. Walsh, *A Treatise on Equity* § 109 (1930); *Restatement of Contracts* § 476 & Comment b. (1931).[11] The fundamental difference between fraud at law and in equity lies in the shift in focus from the *cause* of injury to the *fact* of injury:

> The wrongdoer being the target of courts of law, the "action" through which legal remedies are obtained must be predicated upon fault, the substantive law becomes a system of rights and wrongs, and all its remedies center about redress, vindication, punishment, restitution. In considering the field of preventive justice, the averting or minimizing of injury, the viewpoint shifts radically and with it both the character of the relief and the substantive underlying principles. It is not the *cause* but the *fact* of injury, and the problem of its practical control through judicial action which concern the court.
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> * * * * *
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> [Equity] is not concerned with the vindication of a right or the condemnation of a wrong, it protects merely from injury.

J. Lawrence, *Substantive Law of Equity Jurisprudence* §§ 13, 17 (1929) (emphasis in original). See

[11] Modern authorities also confirm the fundamental proposition that equity regards misrepresentations as fraudulent without proof of scienter. See, *e.g.*, 1 F. Harper & F. James, *The Law of Torts* 603 (1956); W. Prosser, *The Law of Torts* 687 (4th ed. 1971). See also Note, *The Scienter Requirement in SEC Injunctive Enforcement of Section 10(b) After Ernst & Ernst* v. *Hochfelder*, 77 Colum. L. Rev. 419, 428 (1977).

also Shulman, *Civil Liabilities Under the Securities Act*, 43 Yale L.J. 227, 231, 233 (1933).

2. Consistent with this tradition of broad equitable relief against fraud, several state legislatures, prior to the passage of the federal securities laws, enacted their own securities laws with antifraud provisions forbidding the use of deception in securities transactions and creating governmental authority to investigate and seek to enjoin securities frauds. See I L. Loss, *Securities Regulation* 33-34, 35-43 (1961); L. Loss and E. Cowett, *Blue Sky Law* 17-26 (1958). Conspicuous among these state statutes was the New York Martin Act, N.Y. Gen. Bus. Law §§ 352-353 (Consol. 1921), under which the State Attorney General commenced numerous injunctive proceedings to restrain securities frauds. See McCall, *Comments on the Martin Act*, 3 Brooklyn L. Rev. 190, 203 (1934) (2,682 individuals and corporations enjoined between 1931 and 1933). The enforcement pattern under the New York statute is of particular significance in the present context because Congress used the Martin Act as one of its principal models in drafting the Securities Act of 1933, and, more particularly, relied on the Martin Act in formulating the prohibitory language of Section 17(a). See *Securities Act: Hearings on S.875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 253 (1933); *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 11, 109 (1933). See also I Loss, *supra*, at 128; III Loss, *supra*, at 1440. The Martin Act was also cited during the congressional debates

in explaining the injunction provisions under the Securities Exchange Act of 1934. See 78 Cong. Rec. 8096 (1934) (remarks of Rep. Black).

The Martin Act empowered the Attorney General to seek an injunction whenever it appeared that any person had engaged in or was about to engage in a fraudulent securities transaction. N.Y. Gen. Bus. Law §§ 352-353 (consol., 1921). In the landmark case of *People* v. *Federated Radio Corp.*, 244 N.Y. 33, 154 N.E. 655 (1926), the New York Court of Appeals held that securities fraud could be enjoined in equity under the state statute without proof of scienter:

> The words "fraud" and "fraudulent practice" * * * should * * * be given a wide meaning, so as to include all acts, although not originating in any actual evil design or contrivance to perpetrate fraud or injury upon others, which do by their tendency to deceive or mislead the purchasing public come within the purpose of the law.
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> * * * * *
>
> Intentional misstatements, as in an action at law to recover damages for fraud and deceit * * *, need not be alleged. Material misrepresentations intended to influence the bargain, on which an action might be maintained in equity to rescind a consummated transaction, are enough. Promoters are under a duty to make reasonable investigation before issuing a prospectus, and to the extent that they fail in the performance of their duty, lack of scienter will not relieve them from liability in actions brought under the Martin Act.

244 N.Y. at 38-39, 41; 154 N.E. at 657-658.[12] The New York Attorney General's authority to obtain injunctions to restrain securities fraud without proof of intent to deceive or defraud was repeatedly upheld following *Federated Radio*. See *People* v. *Rice*, 221 A. D. 443, 223 N.Y.S. 566 (App. Div. 1927); *People* v. *F.H. Smith Co.*, 136 Misc. 449, 240 N.Y.S. 807 (Sup. Ct.), aff'd in relevant part, 230 A. D. 268, 243 N.Y.S. 446 (App. Div. 1930); *People* v. *Ruocco*, 137 Misc. 400, 242 N.Y.S. 41 (Sup. Ct. 1930); *People* v. *New York City Air Port, Inc.*, 143 Misc. 472, 256 N.Y.S. 89 (Sup. Ct. 1931).[13]

As noted by one commentator summarizing this line of authority shortly before the enactment of the Securities Exchange Act of 1934:

> It is immediately manifest that if the Attorney General were limited in his enforcement of the

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[12] Professor Loss has described *Federated Radio* as "one of the leading cases on the concept of fraud in securities legislation, state or federal." I Loss, *supra*, at 41 n.78.

[13] Contemporary legal commentary on Blue Sky statutes noted that injunctions were available without regard to scienter. See Note, *Liability for Misrepresentations in Corporate Prospectuses*, 40 Yale L.J. 987, 988 (1931). See also Loss and Cowett, *supra*, at 251. The Uniform Sale of Securities Act, approved by the National Conference of Commissioners on Uniform State Laws in 1929, also provided for injunctive relief against deceptive practices. National Conf. of Commissioners on Uniform State Laws, *Handbook and Proceedings* 173-204 (1929). State of mind was an element in the private damage and criminal penalty provisions of the statute (Sections 16 and 17), but not the section authorizing injunctive relief against deceptive practices (Section 15). The Uniform Sale of Securities Act, like New York's Martin Act, was considered by Congress when the Securities Act of 1933 was adopted. See I Loss, *supra*, at 128.

> Act to cases of intentional fraud the result of such interpretation would, in effect, place him in the position of a plaintiff in the common law action of fraud and deceit. It seems equally obvious that such could not have been the purpose of the Legislature, as the nature of the relief provided for in the Act is essentially equitable and designed solely for the protection of the people of the state in general against fraudulent practices in the advertisement or sale of securities.

McCall, *supra*, 3 Brooklyn L. Rev. at 198.

3. These legal principles—that terms describing rights and wrongs may have a different meaning in equity than at law and that scienter is not required when equitable rather than legal relief is sought—underlie this Court's decision in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*. The issue in *Capital Gains* was "whether Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit upon any client or prospective client,' intended to require the Commission to establish fraud and deceit 'in their technical sense,' including intent to injure and actual injury to clients, or whether Congress intended a broad remedial construction of the [Investment Advisers] Act which would encompass nondisclosure of material facts." 375 U.S. at 185-186. The injunction sought by the Commission in *Capital Gains* was intended to require the defendant investment adviser to disclose secret securities transactions that arguably affected the quality of investment advice rendered to clients.

The Commission contended that failure to disclose such transactions defrauded clients within the prohibition of Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-6, which forbids investment advisers to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The district court concluded that the Commission was not entitled to injunctive relief without proof of actual "fraud" or "deceit" in their "technical sense," including intent to defraud. *SEC* v. *Capital Gains Research Bureau, Inc.*, 191 F. Supp. 897, 898-899. This Court disagreed.

The Court began its analysis by considering the background and purpose of the federal securities laws. The Court noted that the securities laws were designed to eliminate abuses in the securities industry "which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. * * * A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." 375 U.S. at 186 (footnotes omitted). The Court added that " '[i]t requires but little appreciation * * * of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry." *Id.* at 186-187, quoting *Silver* v. *New York Stock Exchange*, 373 U.S. 341, 366 (1963).

Considering the remedial purpose of Congress in enacting the federal securities laws and the importance of injunctive relief in protecting investors, the Court remarked (375 U.S. at 192-193; footnotes omitted):

> It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold * * * that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit," intended to require proof of intent to injure and actual injury to clients.
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> This conclusion moreover, is not in derogation of the common law of fraud, as the District Court and the majority of the Court of Appeals suggested. To the contrary, it finds support in the process by which the courts have adapted the common law of fraud to the commercial transactions of our society. It is true that at common law intent and injury have been deemed essential elements in a damage suit between parties to an arm's-length transaction. But this is not such an action. This is a suit for a preliminary injunction in which the relief sought is, as the dissenting judges below characterized it, the "mild prophylactic" * * * of requiring a fiduciary to disclose to his clients * * * his dealings in recommended securities just before and after the issuance of his recommendations.
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> The content of common-law fraud has not remained static as the courts below seem to have assumed. It has varied, for example, with the nature of the relief sought, the relationship between the parties, and the merchandise in issue. It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.

Quoting W. DeFuniak, *Handbook of Modern Equity* 235 (2d ed. 1956), the Court added that "'[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element.'" 375 U.S. at 193. It further explained that strict common law rules "which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue." *Id.* at 194 (footnote omitted). The Court also stated that it was not prepared to assume that Congress was unaware of these principles when it enacted the federal securities laws (id. at 195; footnote omitted):

> We cannot assume that Congress, in enacting legislation to prevent fraudulent practices by investment advisers, was unaware of these developments in the common law of fraud. Thus, even if we were to agree with the courts below that Congress had intended, in effect, to codify the common law of fraud in the Investment Advisers Act of 1940, it would be logical to conclude that Congress codified the common law "remedially" as the courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not "technically" as it has traditionally been applied in damage suits between parties to arm's-length transactions involving land and ordinary chattels.

> The foregoing analysis of the judicial treatment of common-law fraud reinforces our conclusion that Congress, in empowering the courts to enjoin any practice which operates "as a fraud or deceit" upon a client, did not intend to require proof of intent to injure and actual injury to the client. Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation "enacted for the purpose of avoiding frauds," not technically and restrictively, but flexibly to effectuate its remedial purposes.

See also *id.* at 200-201.

The similarities between the present case and *Capital Gains* are apparent.[14] Both cases involve remedial statutes granting broad equitable jurisdiction to the district courts to issue injunctions. Both involve general antifraud provisions of the federal securities laws that are intended to protect investors against deception in securities transactions. And both involve statutes enacted at a time when the distinction between fraud at law and in equity was well established both in general jurisprudence and in the field of securities regulation. These similarities strongly support the conclusion of the court below that injunctive relief is available under Sections 17(a) and 20(b) of the Securities Act of 1933 and Sections 10(b) and 21(d) of the Securities Exchange Act of 1934 without proof by the Commission of intent to deceive or defraud. In a forward-looking injunctive proceeding intended to prevent future injury, as opposed to a private damage action intended to redress past injury, the paramount concern is to stop deception—which has the same potential to cause financial loss whether it results from negligence or intentional misconduct.

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[14] Petitioner argues, in reliance on *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 471 n.11 (1977), that the Court's references in *Capital Gains* to fraud in the equitable sense should be limited to statutes establishing federal fiduciary standards (Br. 14-15). But *Santa Fe* does not support such an argument. *Santa Fe* held only that a breach of fiduciary duty without some element of deception, misrepresentation or nondisclosure is not actionable under Section 10(b). Here, by contrast, petitioner was charged with participating in deception and misrepresentation; the only question is what standard of culpability applies in an action for equitable relief based on that conduct.

Contrary to the assertion of amicus AICPA (Br. 19-20 n.3), *Capital Gains* is not limited to the proposition that "intent to injure" is irrelevant in an SEC injunctive proceeding. This Court also recognized in *Capital Gains* that "intention to defraud or to misrepresent is not a necessary element." 375 U.S. at 193. See also *id.* at 194, 200.

II. The Language And Legislative History Of Section 17(a) Of The Securities Act Of 1933 Confirm that the Commission Need Not Prove Scienter In An Injunctive Proceeding Brought To Restrain Fraudulent Practices

1. The language and legislative history of Section 17(a)(2) and (3) of the Securities Act of 1933 confirm that Congress did not intend to require proof of scienter as a prerequisite to equitable relief against securities fraud. The language of Section 17(a)(2) and (3) does not even suggest that Congress "intended to require the Commission to establish fraud

and deceit 'in their technical sense.' " *SEC* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. at 185. To the contrary, subparagraphs (2) and (3) of Section 17(a) broadly prohibit any person from obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact" and from engaging in "any transaction, practice, or course of business which operates or would operate as a fraud or deceit" in the offer or sale of any security.

Although petitioner argues (Br. 16-17) that scienter should be required under subparagraph (1) of Section 17(a) because that subparagraph uses the phrase "device, scheme, or artifice to defraud," this argument (whatever its merit) has no bearing on subparagraphs (2) and (3). As this Court has recently held, each subparagraph of Section 17(a) "proscribes a distinct category of misconduct. Each succeeding prohibition is meant to cover additional kinds of illegalities—not to narrow the reach of the prior sections." *United States* v. *Naftalin*, No. 78-561 (May 21, 1979), slip op. 5.[15] Limitations applicable to one subparagraph do not restrict the scope of the others. Thus, while petitioner argues that a scienter requirement should be read into Section 17(a)(2) and (3), "[n]othing on the

[15] As this Court has also noted, "we are obliged to give effect, if possible, to every word Congress used. * * * Canons of construction ordinarily suggest that terms connected by a disjunctive be given separate meanings * * *." *Reiter* v. *Sonotone Corp.*, No. 78-690 (June 11, 1979), slip op. 5.

face of the statute supports this reading of it." *United States* v. *Naftalin, supra*, slip op. 3.

The decisions of this Court construing statutory language equivalent to that used in Section 17(a)(3) confirm that scienter is not required. In *SEC* v. *Capital Gains Research Bureau, Inc., supra*, the Court construed the antifraud provision of the Investment Advisers Act of 1940—a provision that forbids advisors "to engage in any transaction, practice, or course of business which operates as a fraud or deceit * * *." See Section 206(2) of the Act, 15 U.S.C. 80b-6(2). The same language also appears in Section 17(a)(3). This Court held in *Capital Gains* that such language does not require a "showing [of] deliberate dishonesty as a condition precedent to protecting investors." 375 U.S. at 200.[16] Moreover, as the Court pointed out in *Ernst & Ernst* v. *Hochfelder, supra*, 425 U.S. at 212, the virtually identical language appearing in Rule 10b-5(c), 17 C.F.R. 240.10b15(c), "arguably * * * could be read as proscribing * * * any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not." The "clear import of the critical phrase in [subparagraph] (3), 'operates as a fraud,' is to focus attention on the *effect* of potentially misleading conduct on the pub-

[16] It is also noteworthy that the language used by Congress in Section 17(a)(3) is even broader than that used in the antifraud provision considered in *Capital Gains*. Section 17(a)(3) forbids practices that "would operate" as a fraud, as well as conduct that does in fact operate in that manner.

lic, not on the culpability of the person responsible." *SEC* v. *Coven*, 581 F.2d 1020, 1026 (2d Cir. 1978) (emphasis in original), cert. denied, 440 U.S. 950 (1979); *Steadman* v. *SEC*, 603 F.2d 1126, 1131-1133 (5th Cir. 1979).

Similarly, subparagraph (2) of Section 17(a) contains an unqualified prohibition against material misstatements or omissions in a securities transaction that are used to obtain the money of another, as this Court noted with respect to the virtually identical language of Rule 10b-5(b) in *Hochfelder*, 425 U.S. at 212. In the words of Professor Loss, "[t]here is nothing on the face of Clause (2) itself which smacks of *scienter* or intent to defraud." III Loss, *supra*, at 1442.

In sum, the language used by Congress shows that intent to deceive or defraud is not required to establish a violation of Section 17(a)(2) and (3). Engrafting an exception onto these provisions to immunize negligent misrepresentations in Commission injunctive proceedings "would create a loophole in the statute that Congress simply did not intend to create." *United States* v. *Naftalin*, *supra*, slip op. 8.[17]

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[17] The great majority of lower court decisions construing Section 17(a)(2) and (3) have also concluded that scienter need not be proven in a Commission injunctive proceeding and that negligence is a sufficient predicate. This is an additional interpretive aid of substantial importance (*Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, 421 U.S. at 731-732, 749; see also *id.* at 760 (Powell, J., concurring)). See *SEC* v. *Blazon Corp.*, No. 77-1904 (9th Cir. Dec. 14, 1979), slip op. 7-10; *Steadman* v. *SEC*, *supra*, 603 F.2d at 1131-1133; *SEC* v. *American Realty Trust*, 586 F.2d 1001, 1006-1007 (4th Cir. 1978) (Section 17(a)(2) only); *SEC* v. *Coven*, *supra*, 581 F.2d at 1026-1027; *SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535, 540-541 (1st Cir. 1976); *SEC* v. *Van Horn*, 371 F.2d 181, 185-186 (7th Cir. 1966); *SEC* v. *Chatham*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,911 at 95,758 (D. Utah 1979); *SEC* v. *Paro*, 468 F. Supp. 635, 647-649 (N.D.N.Y. 1979); *SEC* v. *Wills*, 472 F. Supp. 1250, 1271 (D.D.C. 1978) (Section 17(a)(3) only); *SEC* v. *Jos. Schlitz Brewing Co.*, 452 F. Supp. 824, 831 (E.D. Wis. 1978); *SEC* v. *Western Geothermal & Power Corp.*, [1979] Fed. Sec. L. Rep. (CCH) ¶ 96,920 at 95,859 (D. Ariz. 1979), appeal pending, No. 79-3422 (9th Cir.); *SEC* v. *Southwest Coal & Energy Co.*, 439 F. Supp. 820, 826-827 (W.D. La. 1977), appeal pending, No. 78-1130 (5th Cir.) (Section 17(a)(2) only); *SEC* v. *Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1976), aff'd *sub nom. SEC* v. *Arthur Young & Co.*, 590 F.2d 785 (9th Cir. 1979); *SEC* v. *Shiell*, [1977-1978] Fed. Sec. L. Rep. (CCH) ¶ 96,190 at 92,386 (N.D. Fla. 1977). See also *SEC* v. *Arthur Young & Co.*, *supra*, 590 F.2d at 787 (assuming scienter is not required under Section 17(a)).

Only a few courts have required proof of conduct more culpable than negligence. See *SEC* v. *Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), cert. denied, 420 U.S. 908 (1975) (recognizing that "the standards of culpability may be lower in SEC injunctive suits than in private damage actions," but nonetheless requiring proof of "willful" or "reckless" behavior); *SEC* v. *Cenco, Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC* v. *Randell*, [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,362 (E.D. Va. 1978), appeal pending, No. 78-1386 (4th Cir.).

2. The legislative history of Section 17(a) of the Securities Act of 1933 confirms that Congress intended no deviation from the traditional standards of fraud in equity evolved under the Martin Act (see pages 27-30 *supra*). The antifraud provision that became Section 17(a) originally appeared in identical bills introduced in the House and the Senate. H.R.

4314, 73d Cong., 1st Sess. (Mar. 29, 1933); S. 875, 73d Cong., 1st Sess. (Mar. 29, 1933).[18] Borrowing from the language of the Martin Act but inserting the word "willfully," Section 13 of both bills would have made it unlawful for any person (emphasis supplied):

> *willfully* to employ any device, scheme, or artifice to defraud or to obtain money or property by means of any false pretense, representation, or promise, or to engage in any transaction, practice, or course of business * * * which operates or would operate as a fraud upon the purchaser.[19]

Both the House and Senate committees considered adding to Section 13 of the bills the phrase "with the intent to defraud." [20] As reported out of committee, the Senate version of the antifraud provision retained the word "willfully" and added the phrase "with the

[18] During the House hearings, H.R. 5480 was substituted for H.R. 4314.

[19] The Martin Act (N.Y. Gen. Bus. Law § 352 (Consol. 1932)) defined fraudulent practices to include:

> any device, scheme or artifice to defraud or for obtaining money or property by means of any false pretense, representation or promise * * * or * * * any practice or transaction or course of business * * * which is fraudulent or in violation of law and which has operated or which would operate as a fraud upon the purchaser * * *.

[20] See *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 146 (1933). The phrase "with the intent to defraud" was also included in an early draft of the Senate Bill. See S. 875, 73d Cong., 1st Sess. § 13 (Mar. 29, 1933) (Confidential Committee Print).

intent to defraud" to the first clause quoted above for the express purpose of requiring "fraudulent intent" as an element. See S. 875, 73d Cong., 1st Sess. (Apr. 27, 1933); S. Rep. No. 47, 73d Cong., 1st Sess. 5 (1933).

As reported out of the House Committee, however, the bill eliminated the word "willfully." See H.R. 5480, 73d Cong., 1st Sess. § 16(a) (1933). In addition, the House rejected the proposed addition of the phrase "with the intent to defraud." *Ibid.* In the Conference Committee, the House version of the antifraud provision was adopted instead of the Senate version, and the proposed limitation of the statute to intentional misconduct was thus rejected. H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 12, 27 (1933).

Congress' deliberate elimination of the language of intent from Section 17(a) confirms the purpose that Section 17(a) was intended to serve. Congress contemplated that Section 17(a) would serve a dual function. In the case of criminal prosecutions brought against persons engaged in violations of Section 17(a), Congress provided that the government must establish "willful" behavior. See Section 24 of the Act, 15 U.S.C. 77x.[21] But injunctive relief against violations of Section 17(a), sought under Section

[21] Similarly, as a result of a 1936 amendment to the Securities Exchange Act of 1934 (49 Stat. 1378), "willful" violations of Section 17(a) may also serve as the basis for administrative sanctions. See Section 15(b)(4)(D) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4)(D).

20(b) of the Act, 15 U.S.C. 77t(b), could be obtained without proof of scienter or mens rea. See Douglas and Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 181-182 (1933) (mens rea is required in criminal prosecutions but not injunctive proceedings). See also 77 Cong. Rec. 2919, 2920 (1933) (remarks of Rep. Rayburn).

3. Petitioner appears to concede (Br. 18) that the language and history of Section 17(a) of the Securities Act confirm that Congress did not intend to require proof of scienter under subparagraphs (2) and (3). He argues, however, that if scienter is held to be a requirement under Section 10(b) of the Securities Exchange Act and Rule 10b-5, it should also be required under Section 17(a) pursuant to the doctrine of *in pari materia*.

However, as we demonstrate on pages 44-61, *infra*, Section 10(b) and Rule 10b-5 do not require scienter in the context of Commission injunctive proceedings. Thus, the doctrine of *in pari materia* reinforces the conclusion that scienter should not be required under Section 17(a). In any event, even if Section 10(b) and Rule 10b-5 do require proof of scienter in this context, there would be no warrant for limiting the literal scope of Section 17(a). The doctrine of *in pari materia* cannot restrict plain statutory language. See *Erlenbaugh* v. *United States*, 409 U.S. 239, 243-245 (1972). It cannot be relied on to "introduce an exception" in a statute or to "carve a substantial slice from [its] intended coverage." *Id.* at 245, 247. As the Court noted in *United States* v. *Naftalin*,

supra, slip op. 8 n.8, "subsequent enactments do not serve to restrict the original scope of § 17(a)." [22]

4. Amicus Mid-America Legal Foundation agrees that the language of subparagraphs (2) and (3) of Section 17(a) "might encompass" negligent misconduct, but argues that petitioner cannot be enjoined under these provisions unless he "willfully aided and abetted" the forbidden conduct and that "[i]naction alone will not suffice unless the duty to act is clear" (Amicus Br. 5). Mid-America's arguments were not raised in the petition and are not properly before this Court. In any event, there is no requirement of willfulness in the statutory provisions involved here (see pages 61-65, *infra*), and as a supervisor in a brokerage firm, petitioner's "duty to act [was] clear." [23] As the courts below correctly held, by his inadequate supervision of the firm's salesmen when he knew or should have known of their fraudulent practices, petitioner participated in the fraud that was occurring.[24]

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[22] There is no ground for the assertion that Congress added a scienter requirement in Section 17(a) *sub silentio* when it enacted Section 10(b) in 1934. To the contrary, at the time that Congress was considering the Securities Exchange Act of 1934, it considered and rejected an amendment to Section 17(a) that would have limited that section to conduct that was undertaken "willfully and with intent to deceive." 78 Cong. Rec. 8703 (1934).

[23] See 5A A. Jacobs, *The Impact of Rule 10b-5* § 214.02 at 9-128-132 (1979) (collecting cases). See also Sections 15(b)(4)(E) and 15(b)(6) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4)(E) and 78*o*(b)(6).

[24] See note 23, *supra*. Congress intended to provide injunctive relief against all persons "who have played a material

III. The Language And Legislative History Of Section 10(b) Of The Securities Exchange Act Of 1934 Confirm That The Commission Need Not Prove Scienter In An Injunctive Proceeding Brought To Restrain Fraudulent Practices

Section 10(b) of the Securities Exchange Act of 1934 forbids any person to employ, in connection with the purchase or sale of a security, "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." Rule 10b-5, which was promulgated by the Commission in 1942 (Securities Exchange Act Release No. 3230 (May 21, 1942)), tracks the language of Section 17(a) of the Securities Act. The rule was promulgated to close "a loophole in the protections against fraud administered by the Commission" (*ibid.*) by making "applicable to the purchase of securities, the same broad antifraud provisions * * * imposed in Section 17(a) of the Securities Act of 1933, in connection with the sale of securities." *In re Ward La France Truck Corp.*, 13 S.E.C. 373, 381 n.8 (1943). The rule was needed to harmonize the law applicable to deception because Section 17(a) is limited in certain circumstances to fraudulent practices directed toward purchasers of securities while Section 10(b), as implemented by Rule 10b-5, also reaches fraudulent practices directed toward sellers of securities.

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part in the commission of an enjoinable act, contributors as well as principals * *." *SEC* v. *Barraco*, 438 F.2d 97, 99 (10th Cir. 1971).

Relying on this Court's decision in *Ernst & Ernst* v. *Hochfelder*, *supra*, petitioner argues (Br. 12) that the words "manipulative or deceptive device or contrivance" used in Section 10(b) impose a scienter requirement in equitable proceedings as well as private damage actions. Although recognizing that scienter is not required by the express language of either Section 10(b) or the section of the Act authorizing injunctive relief (Section 21(d), 15 U.S.C. 78u (d)), petitioner nonetheless contends (Br. 12) that the requirement is "implicit" in the statute, citing the Fifth Circuit's decision in *SEC* v. *Blatt*, 583 F.2d 1325, 1333 n.21 (1978).

1. *Hochfelder* does not answer the question whether the Commission must prove scienter in this injunctive proceeding under Section 10(b). This Court was careful to explain in *Hochfelder* that it "need not consider the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5. Cf. *SEC* v. *Capital Gains Research Bureau*, 375 U.S. 180 (1963)." 425 U.S. at 194 n. 12. If the Court had believed that its reasoning in *Hochfelder* was controlling in this different context, it would not have expressly limited its holding and would not have cited its prior decision in *Capital Gains*, a decision which concluded, as we have noted, that " '[f]raud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element' " (375 U.S. at 193).

The question before the Court in *Hochfelder* was "whether a private cause of action for damages will

lie under § 10(b) and Rule 10b-5 in the absence of any allegation of 'scienter' * * *." 425 U.S. at 193. In adopting a scienter requirement under Section 10(b) and Rule 10b-5, the Court brought the elements of a judicially implied cause of action for damages into harmony with the elements of private tort actions based on deceit—actions that are in many respects parallel to implied actions under Section 10(b) (*Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 744 (1975)). The present proceeding is not a private damage action. It is a government enforcement proceeding expressly authorized by Congress to secure prophylactic equitable relief. As this Court has recognized repeatedly, the elements that must be proven in such a statutory enforcement proceeding are different from those in private damage suits. See *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*; *SEC* v. *National Securities, Inc.*, 393 U.S. 453, 467 n.9 (1969). See also *United States* v. *Naftalin*, *supra*, slip op. 5 n.6.

Because the Court considered a private damage action in *Hochfelder*, it was necessary to construe the language of Section 10(b) in a manner that would not result in conflicts with the express private remedy provisions for negligent conduct contained in other parts of the federal securities laws. The Court concluded that implication of a private right of action under Section 10(b) for negligent conduct would disrupt the statutory scheme by "nullify[ing] the effectiveness of the carefully drawn procedural re-

strictions on these express actions." 425 U.S. at 210. In contrast, as the court below correctly observed, "there are no comparable provisions which would be nullified by permitting SEC enforcement actions to be predicated on a showing of negligence" (Pet. App. 18a-19a).

Moreover, the policy considerations that supported the Court's holding in *Hochfelder* are not applicable here. *Hochfelder* reiterated the concern, expressed over 40 years earlier by Judge Cardozo in *Ultramares Corp.* v. *Touche*, 255 N.Y. 170, 174 N.E. 441 (1931), that a private damage remedy based solely on negligence could subject defendants to "liability in an indeterminate amount for an indeterminate time to an indeterminate class." 425 U.S. at 215-216 n.33. Those concerns do not arise in an enforcement proceeding seeking to restrain future misrepresentations. This form of preventive remedy protects the public without imposing draconian liability on persons who have negligently deceived others. The New York courts recognized this distinction, affording equitable relief in the absence of scienter. See *Ultramares Corp.* v. *Touche*, *supra*, 174 N.E. at 447; see also cases cited at pages 28-29, *supra*.

In light of the fundamental differences between this case and *Hochfelder*, the court of appeals correctly concluded that *Hochfelder* is not controlling here; in an injunctive action under Section 10(b), as under Section 17(a), the Court's prior decision in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, affords appropriate guidance. See Note, *The Scienter Requirement in SEC Injunctive En-*

forcement of Section 10(b) After Ernest & Ernst v. *Hochfelder*, 77 Colum. L. Rev. 419 (1977). That conclusion is buttressed by the decisions of the majority of the courts of appeals that have considered the question, which have concluded, both before and after *Hochfelder*, that the Commission need not prove scienter in an equitable enforcement proceeding brought under Section 10(b). See, *e.g.*, *SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535, 541 n.10 (1st Cir. 1976); *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 809 (2d Cir. 1975); *SEC* v. *Dolnick*, 501 F.2d 1279, 1284 (7th Cir. 1974); *SEC* v. *Manor Nursing Centers, Inc.*, 458 F.2d 1082, 1095-1097 (2d Cir. 1972); *SEC* v. *Geyser Minerals Corp.*, 452 F.2d 876, 880-881 (10th Cir. 1971); *SEC* v. *Pearson*, 426 F.2d 1339, 1343 (10th Cir. 1970); *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 863 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969). The only court of appeals decision to the contrary is *SEC* v. *Blatt*, *supra*, which concluded that the scienter standard adopted in *Hochfelder* is applicable both in private damage actions and in Commission injunctive suits.[25]

Judge Friendly's concurring opinion in *SEC* v. *Texas Gulf Sulphur Co.*, *supra*, anticipating this Court's decision in *Hochfelder*, concluded that imposition of private damage liability under Section 10(b) and Rule 10b-5 based on mere negligence is improper (401 F.2d at 866-868). With respect to injunctive relief, however, Judge Friendly concluded, citing this Court's decision in *Capital Gains*, that proof of scienter is not essential. *Id.* at 868.

[25] Cf. also *SEC* v. *Coffey*, *supra*, 493 F.2d at 1314, discussed at note 17, *supra*.

2. We of course recognize that the Court in *Hochfelder* concluded that the language of Section 10(b) is "sufficiently clear *in its context*" to warrant imposition of a scienter standard. 425 U.S. at 201 (emphasis supplied). We submit, however, that the meaning of the words used by Congress is altogether different in the "context" of an injunctive proceeding. As the discussion on pages 24-35, *supra*, shows, it was well settled when Section 10(b) was enacted that equitable remedies were available in the case of deception without proof of scienter. Here, as in *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 195, the Court should not "assume that Congress, in enacting legislation to prevent fraudulent practices * * *, was unaware of these developments in the common law of fraud."[26] Although the decision in *Hochfelder* clearly delineates the requirements of Section 10(b) in the private damage context, it is essential to recall that "general expressions, in every opinion, are to be taken in connection with the case in which those expressions are used." *Zenith Radio Corp.* v. *United States*, 437 U.S. 443, 462 (1978).[27]

[26] If Congress had intended to depart so substantially from this well established doctrine of equity practice, it would have made its desire plain. See *Rondeau* v. *Mosinee Paper Corp.*, 422 U.S. 49, 61 (1975).

[27] Petitioner argues (Br. 11) that the language of Section 10(b) must have the same implication here as in private

Petitioner's conduct, whether negligent or intentional, is properly viewed as a "deceptive device" under Section 10(b) in this equitable proceeding.[28] The word "deceptive" refers to conduct that might or does mislead other persons. *Webster's New International Dictionary* 578 (1933). There is no question here that the registered representatives under petitioner's supervision engaged in deceptive behavior and that petitioner failed to restrain them despite receiving repeated warnings. Viewed from the perspective of the brokerage firm's customers—a part of the class that Congress meant to protect—petitioner's state of mind had no bearing on the "deceptive"

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damage actions. But as *Capital Gains* establishes, the terminology of fraud traditionally has had two separate and distinct meanings—at law and in equity.

[28] Section 10(b) extends to any "manipulative or deceptive device or contrivance." The words of the statute are expressed in the disjunctive, and each should be given its separate meaning. *Reiter* v. *Sonotone Corp., supra,* slip op. 7; *United States* v. *Naftalin, supra,* slip op. 5. The terms of Section 10(b) that directly apply to petitioner's conduct are "deceptive device." We note, however, that even the word "manipulative" does not always refer to conduct involving scienter, particularly in an injunctive proceeding. For example, a recommendation on the basis of false information may be a form of manipulation in violation of Section 9(a)(4) of the Securities Exchange Act, 15 U.S.C. 78i(a)(4). A broker or other person selling a security registered on a national securities exchange on the basis on such a recommendation may be enjoined from such manipulative activity if he is merely negligent—*i.e.*, if he has "reasonable ground to believe" that his recommendations are untrue. *Ibid.* See *Ernst & Ernst* v. *Hochfelder, supra,* 425 U.S. at 209 n.28.

effect of the course of conduct in which he participated.

Moreover, the word "device," although often connoting an intentional scheme to defraud, does not necessarily have such meaning. As this Court explained in *Armour Packing Co.* v. *United States,* 209 U.S. 56, 71 (1908), "[a] device need not be necessarily fraudulent * * *." The Court concluded in *Armour Packing Co.* that the Elkins Act (32 Stat. 847) prohibits all "devices" to obtain rebates or preferences: "Had it been the intention of Congress to limit the obtaining of such preferences to fraudulent schemes or devices, or to those operating only by dishonest, or underhanded methods, it would have been easy to have so provided in words that would be unmistakable in their meaning." Furthermore, Congress used the word "device" in another antifraud provision of the Securities Exchange Act to encompass not just intentional fraud but also negligent acts and practices. See Section 15(c)(1), 15 U.S.C. 78*o*(c)(1); Rule 15c1-2, 17 C.F.R. 240.15c1-2.[29]

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[29] In 1937, only three years after the passage of the Securities Exchange Act, the Commission, by rule, defined the phrase "any manipulative, deceptive, or other fraudulent device or contrivance" appearing in Section 15(c) of the Act (now Section 15(c)(1)) to include "any act, practice, or course of business which operates or would operate as a fraud or deceit" and "any untrue statement of a material fact or omission to state a material fact" where the statement or omission is made with knowledge "or reasonable grounds to believe" that it is untrue or misleading (Rule MC2, Securities Exchange Act Release No. 1330 (Aug. 4, 1937)). In 1938, Congress considered and expressly approved the Commission's

The legislative history of Section 10(b), like the statutory language, does not require an interpretation that would mandate proof of scienter in an injunctive proceeding. The history is virtually silent with respect to the word "deceptive," since that word was not added to the Senate version of Section 10(b) until the final drafts of the bill neared completion. See S. ——, 73d Cong., 2d Sess. § 9(b) (Apr. 14, 1934) (Confidential Committee Print). The word "deceptive" was never included in the House version of Section 10(b). See H.R. 9323, 73d Cong., 2d Sess. (1934); H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 32 (1934).

Similarly, the legislative history of the Securities Exchange Act does not indicate that the word "device" requires proof of scienter in an equitable proceeding. To the contrary, the Senate Committee Report uses the term "device" synonymously with "practice." See S. Rep. No. 792, 73d Cong., 2d Sess. 18 (1934), describing the "devices" forbidden by Section 10(b) as "any other manipulative or deceptive practices which [the Commission] finds detrimental to the interests of the investor." See also *id.* at 7; H.R. Rep. No. 1383, 73d Cong., 2d Sess. 10 (1934). Of course, the word "practice" denotes an "action" or "deed" and does not imply intentional wrongdoing. See *Webster's New International Dic-*

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rule when it amended Section 15(c). H.R. Rep. No. 2307, 75th Cong., 3d Sess. 10 (1938); S. Rep. No. 1455, 75th Cong., 3d Sess. 4, 10 (1938); *Regulation of Over-the-Counter Markets: Hearings on S. 3255, H.R. 9634 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 75th Cong., 3d Sess. 13-14, 84-86 (1938).

tionary 1937 (1933). Further, the Senate Report used the word "device" to refer to "the dissemination of false information" (S. Rep. No. 792, 73d Cong., 2d Sess. 8 (1934)), in describing a provision of the bill related to Section 10(b) that would have prohibited misleading statements made to induce the purchase or sale of a listed security without a requirement of culpability. S. 3420, 73d Cong., 2d Sess. § 9(a)(4) (Apr. 20, 1934).

Finally, as this Court observed in *Hochfelder*, the committee reports, in describing the express damage liability sections of the Securities Exchange Act, indicate an intent to relieve a defendant from "damages stemming from 'illicit practices,' where the defendant has * * * acted in good faith." 425 U.S. at 206. There is no indication in the committee reports, however, of any similar intention to relieve a defendant who has engaged in "illicit practices" from the restraint against recurrence of such misconduct provided by an injunction.

In sum, while the language and history of Section 10(b) are supportive of the Court's conclusion that scienter is required in an action for damages—the kind of fraud action in which scienter has traditionally been required by courts of law—they do not support petitioner's different assertion that Congress intended that scienter be proven in an equitable proceeding as a prerequisite to obtaining preventive relief.

3. The Commission's consistent interpretation has been that negligent behavior that deceives investors is a sufficient predicate for injunctive relief under Section 10(b). As noted on page 48 *supra*, the

Commission has succesfuly argued before several courts of appeals that injunctive relief is available under Section 10(b) in such circumstances. That interpretation was accepted by the United .States Court of Appeals for the Second Circuit sitting en banc in *SEC* v. *Texas Gulf Sulphur Co., supra,* which was handed down in 1968. Since that time, the First, Seventh and Tenth Circuits have agreed.

Congress was expressly informed of this administrative interpretation on at least two occasions when significant amendments to the federal securities laws were enacted. On each occasion, Congress left the administrative interpretation undisturbed. In 1975, Congress passed the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97. Those amendments have been described as the "most substantial and significant revision of this country's federal securities laws since the passage of the Securities Exchange Act in 1934." *Securities Acts Amendments of 1975: Hearings on S. 249 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs,* 94th Cong., 1st Sess. 1 (1975). In the process of considering this reform, Congress addressed both the purpose and scope of Commission injunctive remedies. In its report on the bill that ultimately became the Securities Acts Amendments of 1975, the Senate Committee on Housing, Banking and Urban Affairs (which exercises principal oversight responsibility with respect to the Commission) stated:

> [A]lthough both the Commission's suit for injunctive relief brought pursuant to express statutory authority and a private action for damages fall within the general category of civil (as distinct from criminal) proceedings, their objectives are really very different. Private actions for damages seek to adjudicate a private controversy between citizens; the Commission's action for civil injunction is a vital part of the Congressionally mandated scheme of law enforcement in the securities area.
>
> Private actions frequently will involve more parties and more issues than the Commission's enforcement action, thus greatly increasing the need for extensive pretrial discovery. In particular, issues related to * * * scienter, causation, and the extent of damages, are elements *not* required to be demonstrated in a Commission injunctive action.

S. Rep. No. 94-75, 94th Cong., 1st Sess. 76 (1976) (emphasis in original). On the basis of its understanding that proof of scienter and other elements relevant in private damage litigation was *not* required in Commission injunctive proceedings, Congress enacted Section 21(g) of the Act, 15 U.S.C. 78u(g), which provides that, absent consent from the Commission, private actions—raising questions such as the defendant's scienter—may not be consolidated with Commission proceedings.

In 1977, following this Court's decision in *Hochfelder,* Congress enacted the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1495, which amended the Securities Exchange Act of 1934.

Once again, the Commission's interpretation that scienter is not required in injunctive actions was reviewed. See H.R. Rep. No. 95-640, 95th Cong., 1st Sess. 10 (1977) (emphasis omitted):

> Although the Supreme Court has held that private plaintiffs seeking to recover monetary damages for violations of Securities Exchange Act Rule 10b-5 * * * must establish that the defendant acted with scienter, the appellate courts quite properly have never required proof of scienter in any of the Commission's own enforcement proceedings. Compare *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) with *Securities and Exchange Commission* v. *World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976); *Securities and Exchange Commission* v. *Management Dynamics, Inc.*, 515 F.2d 801 (2d Cir. 1975); *Securities and Exchange Commission* v. *Spectrum, Ltd.*, 489 F.2d 535 (2d Cir. 1973). In the context of an SEC action to enjoin future violations of the securities laws, a defendant's state of mind should make no difference. The harm to the public is the same regardless of whether or not the violative conduct involved scienter. Because an SEC enforcement action is designed to protect the public against the recurrence of violative conduct, and not to punish a state of mind, this Committee intends that scienter is not an element of any Commission enforcement proceeding. In so stating, we reaffirm the views expressed in 1975, when the Congress considered the Securities Acts Amendments of 1975. See S. Rep. 94-75, 94th Cong., 1st Sess. (1975) at 76.

Although the Conference Committee stated that consideration of the 1977 amendments was not an appropriate occasion to debate the merits of this Court's *Hochfelder* decision (H.R. Conf. Rep. No. 95-831, 95th Cong., 1st Sess. 11 (1977)), there can be no doubt that the Commission's view concerning a state of mind requirement in injunctive proceedings was clearly brought to the attention of Congress when the 1977 amendments were approved.

This Court has recognized that consistent interpretations of the Commission, which are compatible with the text and purpose of the securities laws, are entitled to deference. See, *e.g.*, *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694, 718-719 (1975); *E.I. du Pont de Nemours & Co.* v. *Collins*, 432 U.S. 46, 54-55 (1977). That principle takes on added significance when Congress has expressly reviewed the administrative interpretation while amending the securities laws and has left it undisturbed. See, *e.g.*, *Andrus* v. *Allard*, No. 78-740 (Nov. 27, 1979), slip op. 6 ("it is particularly relevant that Congress has twice reviewed and amended the statute without rejecting the Department's view"); *United States* v. *Rutherford*, No. 78-605 (June 18, 1979), slip op. 8-9 & n.10 ("once an agency's statutory construction has been 'fully brought to the attention of the public and the Congress,' and the latter has not sought to alter that interpretation although it has amended the statute in other respects, then presumably the legislative intent has been correctly discerned"); *Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234, 248 (1978) ("Congress has been made aware of this [administra-

tive] practice, yet four times has 'revisited the Act and left the practice untouched' "); *Lorillard* v. *Pons*, 434 U.S. 575, 580 (1978) ("Congress is presumed to be aware of an administrative or judicial interpretation of a statute and to adopt that interpretation when it reenacts a statute without change"); *Saxbe* v. *Bustos*, 419 U.S. 65, 74 (1974) ("Such a history of administrative construction and congressional acquiescence may add a gloss or qualification to what is on its face unqualified statutory language"); *NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 274-275 (1974); *Red Lion Broadcasting Co.* v. *FCC*, 395 U.S. 367, 381 (1969).

In sum, the consistent administrative interpretation of the statute, construing Section 10(b) to allow injunctive relief without proof of scienter, not only agrees with prior decisions of this Court and the lower federal courts, but also enjoys the presumptive approval of Congress.

4. Finally, interpretation of Section 10(b) and Rule 10b-5 to permit injunctive relief without proof of scienter would harmonize these provisions with Section 17(a), the parallel antifraud provision contained in the Securities Act of 1933. As discussed on pages 35-43, *supra*, Section 17(a) does not impose a scienter requirement in Commission enforcement actions. However, Section 17(a) only extends to deceptive or misleading practices in the offer or sale of securities. If Section 10(b) were construed to impose a scienter requirement in injunctive actions, the protection afforded to public investors would be haphazard and fortuitous, depending on whether the deceived investor was a "buyer" or a "seller" of securities. Under such a construction, frauds practiced on sellers would be subject to equitable restraint under Section 10(b) only if the Commission could prove scienter, whereas frauds practiced on buyers could be restrained under Section 17(a) based on a showing of negligence.

This illogical construction would run counter to the underlying congressional purpose in enacting the securities laws—to provide fair and effective protection for all investors against deceptive practices. See, *e.g.*, 77 Cong. Rec. 2918 (1933) (remarks of Rep. Rayburn) ("The purpose of this bill is to place the owners of securities on a parity, so far as is possible, with the management of the corporations, and to place the buyer on the same plane so far as available information is concerned, with the seller"). See also Section 2 of the Securities Exchange Act, 15 U.S.C. 78b. Such an interpretation "would create a loophole in the statute that Congress simply did not intend to create." *United States* v. *Naftalin*, *supra*, slip op. 8.[30]

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[30] An interpretation of Section 10(b) and Rule 10b-5 that permits injunctive relief on the basis of negligence would also harmonize the treatment of listed and unlisted securities. If scienter is required under Section 10(b), Section 9(a)(4) will nevertheless prohibit misrepresentations, not involving scienter, made to induce transactions in securities listed on a national securities exchange. See note 28, *supra*. No comparable prohibition would apply to unlisted securities. The availability of injunctive relief, however, should not depend on whether the securities involved are listed.

The words of the Securities Exchange Act should not be construed in a manner that conflicts with the "purpose" and "spirit" of the legislation. See *United Housing Foundation, Inc.* v. *Forman, supra,* 421 U.S. at 849, citing *United States* v. *American Trucking Ass'ns, Inc., supra,* 310 U.S. at 543 (statutory terms should not be interpreted to produce an "unreasonable" result " 'plainly at variance with the policy of the legislation as a whole' "). Indeed, construing Section 10(b) in a way that is consistent with its remedial purpose and that would harmonize its operation with Section 17(a) would be in accord with the principle of statutory interpretation frequently applied by the Court under Section 10(b). See *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, 151 (1972) .("Congress intended securities legislation enacted for the purpose of avoiding frauds to be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes' "); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6, 12 (1971); *SEC* v. *National Securities, Inc., supra,* 393 U.S. at 467; *Tcherepnin* v. *Knight,* 389 U.S. 332, 336 (1967). Permitting the Commission to obtain injunctive relief under Section 10(b) to avoid deceptive practices in securities transactions without proof of scienter plainly would facilitate the statute's remedial purpose.

IV. The Structure Of The Securities Act Of 1933 And The Securities Exchange Act Of 1934 Confirms That The Commission Need Not Prove Scienter In An Injunctive Proceeding

As discussed above, the history and text of Sections 17(a) and 10(b) establish that they do not require scienter in an injunctive proceeding brought by the Commission to restrain deceptive practices. This interpretation is reinforced by the traditional meaning of securities fraud in equity, as summarized by the Court in *SEC* v. *Capital Gains Research Bureau, Inc., supra.* As we demonstrate below, the conclusion that scienter is not required in the present context becomes even more apparent when the language Congress used to prescribe state of mind standards throughout the securities laws is compared to the language employed in Sections 17(a) and 10(b), as well as in Sections 20(b) and 21(d), the statutory provisions authorizing injunctive relief.

The words repeatedly used by Congress in the Securities Act and the Securities Exchange Act, as well as in subsequent federal securities legislation, to denote state of mind standards are forms of the words "knowing,"[31] "willful,"[32] and "good

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[31] See Sections 10(a)(3), 11(a), 11(b)(2), 11(e), 12(2) and 15 of the Securities Act, 15 U.S.C. 77j(a)(3), 77k(a), 77k(b)(2), 77k(e), 77*l*(2) and 77*o*; Sections 9(a)(1)(C), 9(a)(4), 18(a), 29(b), 29(c) and 32(a) of the Securities Exchange Act, 15 U.S.C. 78i(a)(1)(C), 78i(a)(4), 78r(a), 78cc(b) and 78cc(c) and 15 U.S.C. (Supp. I) 78ff(a). When Congress amended the Securities Exchange Act in 1964, 1975 and 1977, it continued to use this language. See Sections 3(a)(39)(D), 6(c)(2), 15(b)(6), 15A(g)(2), 15B(c)(4),

17A(b)(4)(A) and 30A(a)(3) of the Securities Exchange Act, 15 U.S.C. 78c(a)(39)(D), 78f(c)(2), 78*o*(b)(6), 78*o*-3(g)(2), 78*o*-4(c)(4) and 78q-1(b)(4)(A) and 15 U.S.C. (Supp. I) 78dd-1(a)(3). Similarly, Congress used this language in Sections 26(b), 26(c) and 29 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z(b), 79z(c) and 79z-3; Sections 310(b)(7), 310(b)(8), 313(a)(1) and 323(a) of the Trust Indenture Act of 1939, 15 U.S.C. 77jjj(b)(7), 77jjj(b)(8), 78mmm(a)(1) and 77www(a); Sections 10(f), 12(d)(1)(B), 17(a)(1), 17(a)(2), 20(d), 47(b) and 49 of the Investment Company Act of 1940, 15 U.S.C. 80a-10(f), 80a-12(d)(1)(B), 80a-17(a)(1), 80a-17(a)(2), 80a-20(d), 80a-46(b) and 80a-48; and Sections 203(f), 206(3) and 215(b) of the Investment Advisers Act of 1940, 15 U.S.C. 80b-3(f), 80b-6(3) and 80b-15(b).

[32] See Section 24 of the Securities Act, 15 U.S.C. 77x; Sections 9(e) and 32(a) of the Securities Exchange Act, 15 U.S.C. 78i(e) and 78ff(a). When Congress amended the Securities Exchange Act in 1936 to provide administrative remedies, it specified when proof of willful misconduct was required. See Section 15(b)(4)(A), (D) and (E) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4)(A), (D) and (E). Congress continued this pattern in subsequent years when it further amended the Securities Exchange Act. See Sections 3(a)(39)(E), 15B(c)(4), 17A(c)(3)(A), 19(h)(2), 19(h)(3), 19(h)(4), 32(c)(2) and 32(c)(3), 15 U.S.C. 78c(a)(39)(E), 78*o*-4(c)(4), 78q-1(c)(3)(A), 78s(h)(2), 78s(h)(3) and 78s(h)(4) and 15 U.S.C. (Supp. I) 78ff(c)(2) and 78ff(c)(3). In other securities statutes Congress frequently used the word "willful" to denote a state of mind requirement. See Section 29 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z-3; Section 325 of the Trust Indenture Act, 15 U.S.C. 77yyy; Sections 9(b)(1), 9(b)(2), 9(b)(3), 17(h), 17(i), 34(a), 37 and 49 of the Investment Company Act of 1940, 15 U.S.C. 80a-9(b)(1), 80a-9(b)(2), 80a-9(b)(3), 80a-17(h), 80a-17(i), 80a-33(a), 80a-36 and 80a-48; Sections 203(e)(1), 203(f), 207 and 217 of the Investment Advisers Act, 15 U.S.C. 80b-3(e)(1), 80b-3(f), 80b-7 and 80b-17.

faith."[33] The concept of state of mind is treated with precision, and the omission of such language in Sections 17(a), 10(b), 20(b) and 21(d) therefore cannot be attributed to oversight. If Congress had intended to depart from the traditional doctrine of fraud in equity—a departure that should not lightly be presumed (see *SEC* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 192-195)—it would have said so expressly. See *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, *supra*, slip op. 8-10; *Blue Chip Stamps* v. *Manor Drug Stores*, *supra*, 421 U.S. at 734. As the Court observed in *Hecht Co.* v. *Bowles*, 321 U.S. 321, 329 (1944), "if Congress had intended to make such a drastic departure from the traditions of equity practice, an unequivocal statement of its purpose would have been made."

A comparison of Sections 20(b) and 21(d), which empower the district courts to enjoin unlawful practices in securities transactions, with provisions authorizing other governmental remedies highlights

[33] See Section 19(a) of the Securities Act, 15 U.S.C. 77s(a); Sections 16(b), 16(c), 18(a), 20(a), 23(a)(1), 28(e)(1) and 29(c) of the Securities Exchange Act, 15 U.S.C. 78p(b), 78p(c), 78r(a), 78t(a), 78w(a)(1), 78bb(e)(1) and 78cc(c). See also Sections 3(c), 17(b), 20(d) and 26(c) of the Public Utility Holding Company Act, 15 U.S.C. 79c(c), 79q(b), 79t(d) and 79z(c); Sections 315(d)(2), 315(d)(3), 319(c) and 323(a) of the Trust Indenture Act, 15 U.S.C. 77*ooo*(d)(2), 77*ooo*(d)(3), 77sss(c) and 77www(a); Sections 3(b)(2), 12(f) and 38(c) of the Investment Company Act of 1940, 15 U.S.C. 80a-3(b)(2), 80a-12(f) and 80a-37(c); and Section 211(d) of the Investment Advisers Act, 15 U.S.C. 80b-11(d).

the significance of the absence of state of mind language in the injunction provisions. In sharp contrast to certain statutory provisions authorizing administrative sanctions against persons who "willfully" violate the securities laws,[34] and unlike the provisions authorizing criminal prosecutions of persons who "willfully" commit securities violations,[35] Sections 20(b) and 21(d) require a "proper showing" for an injunction to issue. Although a district court, in determining whether a proper showing has been made, may consider scienter as one of several aggravating or mitigating factors in exercising its equitable discretion to grant injunctive relief (see, *e.g.*, *SEC* v. *Universal Major Industries Corp.*, 546 F.2d 1044, 1048 (2d Cir. 1976), cert. denied, 434 U.S. 834 (1977)), the statute does not

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[34] See Section 15(b)(4)(A), (D) and (E) and Section 15B(c)(4) of the Securities Exchange Act, 15 U.S.C. 78*o* (b)(4)(A), (D) and (E), and 78*o*-4(c)(4). See also Section 9(b) of the Investment Company Act, 15 U.S.C. 80a-9(b); Section 203(e)(1), (4), (5) of the Investment Advisers Act, 15 U.S.C. 80b-3(e)(1), (4), (5).

[35] See Section 24 of the Securities Act, 15 U.S.C. 77x; Section 32(a) of the Securities Exchange Act, 15 U.S.C. (Supp. I) 78ff(a). See also Section 29 of the Public Utility Holding Company Act of 1935, 15 U.S.C. 79z-3; Section 325 of the Trust Indenture Act of 1939, 15 U.S.C. 77yyy; Section 49 of the Investment Company Act of 1940, 15 U.S.C. 80a-48; Section 217 of the Investment Advisers Act of 1940, 15 U.S.C. 80b-17.

impose a scienter or other state of mind requirement.[36]

The statutory design summarized above manifests a clear congressional purpose to eliminate securities fraud. Congress has prescribed a variety of remedies to protect the public against deceptive practices in securities transactions. Yet under petitioner's proposed interpretation of the Securities Act and the Securities Exchange Act, the Commission could not obtain the mild prophylactic remedy of injunctive relief without proof of a state of mind that would justify imposition of a severe prison sentence. A district court that finds both that a defendant has engaged in deceptive securities practices and that he is likely to continue to do so unless restrained would be powerless to protect the public against serious financial losses without proof of intent to deceive. The structure of the Acts confirms that Congress did not intend such an illogical result.[37]

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[36] Moreover, in two provisions regulating conduct similar to that covered by Sections 17(a) and 10(b), Congress prescribed that proof of state of mind was a prerequisite to obtaining money damages, but not to obtaining injunctive relief. Compare Section 9(e) of the Securities Exchange Act, 15 U.S.C. 78i(e), with Section 9(a)(4) of the Securities Exchange Act, 15 U.S.C. 78i(a)(4). See *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 209 n.28; note 28, *supra*.

[37] Amicus AICPA argues (Amicus Br. 16) that the court of appeals erred in stating that the same pattern of culpability requirements fashioned by Congress in the Securities Act of 1933 was incorporated in the Securities Exchange Act of 1934, noting that the section relied on by the court of appeals

V. Imposition Of A Scienter Standard In Commission Injunctive Proceedings Would Undermine The Intention Of Congress To Eliminate Deception In Securities Transactions

As a final step in statutory interpretation, it is appropriate to consider the practical consequences of the competing interpretations that are proposed and their consistency with the overall purposes of the legislation.[38] Petitioner agrees, contending that the Court should give consideration to the adverse effects of injunctions on persons restrained from engaging in deceptive behavior (Br. 14 n.12). This line of

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(Section 210 of Title II of the 1934 Act, 48 Stat. 905) "merely transfers the administration of the 1933 Act from the Federal Trade Commission to the Securities and Exchange Commission." As officially reported, however, the court of appeals' opinion omits reference to Section 210 and states (605 F.2d at 622 n.14):

> By incorporating in the 1934 Act the same pattern of culpability requirements established by the 1933 Act, namely, by requiring willfulness both in criminal prosecutions under the Act * * * and in suspending or revoking the registration of a broker or dealer * * *, Congress clearly indicated its rejection of a scienter standard for injunctive relief * * * in that [the section authorizing such injunctive relief under the 1934 Act] has no requirement of willfulness.

[38] Consistent with the purposes discussed below, the proposed Federal Securities Code—approved by both the American Law Institute (Supplement to Proposed Official Draft, July 15, 1978) and the American Bar Association (65 A.B.A.J. 295, 341 (1979))—provides that the Commission, unlike private parties seeking damages, will be able to obtain an injunction to prevent deception and misrepresentation without proof of scienter. See Sections 262(d), 297(a), 1602(a), 1819(a)(3), and 1819(a)(4) (Proposed Official Draft, Mar. 15, 1978).

argument, however, completely ignores the vital role that Commission injunctive proceedings play in preventing the serious harm to investors and the economy that can flow from false and misleading financial information.

1. As noted above, Sections 17(a) and 10(b) are the primary antifraud provisions of the Securities Act and the Securities Exchange Act; they are the principal statutory provisions through which the Commission, in injunctive proceedings, seeks to protect the public against deception in securities transactions. If deception stemming from carelessness is not prohibited by these statutory provisions, the economic interests of participants in the securities markets would be seriously impaired. Financial information disseminated in the national securities markets is used by individual investors, as well as by institutional investors such as bank trust departments, insurance companies, mutual funds, pension funds, arbitrageurs, securities dealers, and corporations engaged in tender offers. As this Court has observed, "the welfare of investors and financial intermediaries are inextricably linked—frauds perpetrated upon either business or investors can redound to the detriment of the other and to the economy as a whole." *United States* v. *Naftalin*, *supra*, slip op. 7. The general public depends heavily on financial information disseminated by persons such as securities brokers, corporations issuing financial data, and accountants certifying financial statements, in making investment decisions of substantial importance, whether it be the investment of the life savings of an

individual or a tender offer for securities by a corporate bidder.

"In our complex society," Judge Friendly has remarked, false and misleading representations about financial matters "can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." *United States* v. *Benjamin*, 328 F.2d 854, 863 (2d Cir.), cert. denied, 377 U.S. 953 (1964). Under modern tort doctrine, persons who make material representations in connection with financial transactions are required to exercise reasonable care to avoid deceiving other persons whose economic interests depend on the truthfulness of such representations. See, *e.g.*, *Restatement (Second) of Torts* Section 552 (1977). Likewise, if, through carelessness, false information is conveyed, and the resulting deception threatens to be recurrent and injurious, the district courts should not be powerless to protect the public through the prophylactic remedy of an injunction under the securities laws. An injunction in such circumstances does not, of course, rest on blameless conduct. To the contrary, that injunction is directed to a defendant whose conduct has fallen below the standard of care that reasonable men would exercise in the circumstances and which threatens to cause continuing injury to the investing public.

The reported cases clearly illustrate the essential role of injunctions in protecting the public against negligent dissemination of false information in connection with securities transactions. See, *e.g.*, *SEC* v. *World Radio Mission, Inc.*, *supra*, 544 F.2d at 539-

541 (negligent failure to disclose issuer corporation's financial deficit and minimal earnings power during securities offering); *SEC* v. *Manor Nursing Centers, Inc.*, *supra*, 458 F.2d at 1095-1097 (negligent failure to correct false prospectus after defendants received notice of material errors); *SEC* v. *Management Dynamics, Inc.*, *supra*, 515 F.2d at 803-805, 809 (negligent misstatements in press release and letter disseminated to the investing public); *SEC* v. *American Realty Trust Co.*, 586 F.2d 1001, 1004-1007 (4th Cir. 1978) (negligent misstatements in prospectus and proxy statement filed with the Commission and disseminated to investors); *SEC* v. *Van Horn*, 371 F.2d 181, 184 (7th Cir. 1966) (negligent misrepresentations concerning the financial condition of the issuer company during offer and sale of securities). In each case, the negligence of the defendants had the clear potential to mislead investors and cause serious financial losses. And in each case, the injunction imposed by the court protected the public by requiring the defendants to cease engaging in deceptive practices.

2. To foreclose injunctive relief where deception has resulted from failure to exercise due care would be contrary to Congress' purposes in enacting the federal securities laws. The Securities Act of 1933 and the Securities Exchange Act of 1934 were enacted in "the aftermath of the market crash in 1929." *Ernst & Ernst* v. *Hochfelder*, *supra*, 425 U.S. at 194. The two statutes are "interrelated components of the federal regulatory scheme governing transactions in securities" (*id.* at 206), a scheme of federal super-

vision intended to "bring back public confidence" in the national securities markets by "add[ing] to the ancient rule of *caveat emptor*, the further doctrine 'let the seller also beware.'" President's Message to Congress (Mar. 29, 1933), reproduced in S. Rep. No. 47, 73d Cong., 1st Sess. 6-7 (1933) and H.R. Rep. No. 85, 73d Cong., 1st Sess. 1-2 (1933).

In the view of Congress, the dissemination of false and misleading information to the investing public had triggered a crisis in confidence in the securities markets and had contributed to the breakdown in the national economy (H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933)):

> The background of the President's message is only too familiar to everyone. During the post-war decade some 50 billions of new securities were floated in the United States. Fully half or $25,000,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities. The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise. Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises.

The House Report added that "[e]qually significant with these countless individual tragedies is the wastage that this irresponsible selling of securities has caused to industry." *Ibid.* The Senate Report that preceded passage of the Securities Act tells a similar story (S. Rep. No. 47, 73d Cong., 1st Sess. 2 (1933)):

> The necessity for the bill arises out of the fact that billions of dollars have been invested in practically worthless securities, both foreign and domestic, including those of foreign governments, by the American public through incomplete, careless, or false representations. The result is dire national distress. * * * [T]he losses of investors have been appalling. Those who have considered the matter place such losses in this country at $1,700,000,000 annually * * *.

See also 77 Cong. Rec. 2919, 2950-2951, 2983 (1933); Stock Exchange Regulation, Report to the Secretary of Commerce, 73d Cong., 2d Sess. 3, 19 (1934). Congress' concern about the effect on the public and the economy of negligent dissemination of false information appears throughout the legislative history. See, e.g., S. Rep. No. 47, 73d Cong., 1st Sess. 2 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess. 2, 3, 5, 9, 22-23 (1933); H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 26 (1933); H.R. Conf. Rep. No. 1838, 73d Cong., 2d Sess. 27-29, 32 (1934). As this Court has noted, the securities legislation that resulted from these concerns was intended to impose on securities

profesionals a " 'high standard of business ethics * * *.' " *United States* v. *Naftalin, supra*, slip op. 6; *SEC* v. *Capital Gains Research Bureau, Inc., supra*, 375 U.S. at 186-187.

An interpretation of the securities laws permitting the Commission to restrain deceptive practices resulting from negligence is essential in curtailing the abuses that Congress meant to eliminate.[39]

3. Petitioner and amicus AICPA nonetheless argue (Pet. Br. 13-14; Amicus Br. 22-27) that the burdens and collateral consequences flowing from an injunction are often substantial and militate against allowing the Commission to obtain injunctive relief in a case such as this.[40] It is undeniable that persons

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[39] Although amicus AICPA suggests (Amicus Br. 23) that an inference of scienter might be drawn from persistence in a course of negligent conduct, the fact that scienter may be established in this way in some cases does not minimize the importance of injunctive relief in other negligence cases. The public is entitled to protection when continued negligent deception is a reasonable prospect, even though the defendant's conduct does not fairly support an inference that he acted with scienter or will in the future act with scienter.

[40] This argument derives no support whatsoever from the governing statutes. Nothing in the language of the injunctive and antifraud provisions links the propriety of granting injunctive relief to the possible collateral consequences that might follow. The administrative disciplinary sanctions under the securities laws to which petitioner refers were not part of the Securities Act or the Securities Exchange Act at the time that the injunctive and antifraud provisions were enacted in 1933 and 1934. Moreover, the collateral consequences to which petitioner refers apply only to a limited category of persons. Thus, they cannot logically be relied on to

enjoined for deceiving others may sometimes suffer inconvenience and disability as a result of a judicial restraining order. But these considerations are hardly a justification for permitting those engaged in deception to continue their conduct. Those who depart from professional standards by deceiving others and who threaten to continue to do so are properly subject to an injunctive order: "[T]he propriety of an injunction depends largely on the relative culpability of the violation. The weapon is best suited for application to negligent malfeasors whose future compliance may be stimulated by a judicial mandate * * *." Note, *The Statutory Injunction As An Enforcement Weapon of Federal Agencies*, 57 Yale L.J. 1023, 1046-1047 (1948).

Indeed, the argument of amicus AICPA that negligent conduct, resulting in the deception of investors, should not be subject to a corrective order to protect the public is difficult to square with its own statements in 2 AICPA Professional Standards (CCH), Sections 50.01-50.02: "A distinguishing mark of a professional is his acceptance of responsibility to the public * * *. The reliance of the public, the government and the business community on sound financial reporting and advice on business affairs, and the importance of these matters to the economic and social aspects of life impose particular obliga-

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require proof of scienter in proceedings brought to enjoin future violations of antifraud provisions that apply to "any person."

tions on certified public accountants." Negligence by professionals such as brokers and accountants may expose them to legal consequences far more serious than injunctive relief. Negligent mispresentations may result in common law tort claims for money damages. Compare *Restatement (Second) of Torts*, *supra*, Section 552 (scienter not required when information is supplied by a professional for the guidance of others in business transactions) with Sections 525 and 526 (scienter is generally required in a tort action for fraudulent misrepresentation); see *Rhode Island Hospital Trust Nat. Bank* v. *Swartz*, 455 F.2d 847 (4th Cir. 1972). Misrepresentations that are negligent can also lead to liability in money damages under the federal securities laws. See, *e.g.*, Sections 11 and 12(2) of the Securities Act of 1933, 15 U.S.C. 77k, 77*l*(2). See also *Wilko* v. *Swan*, 346 U.S. 427, 430-431 (1953).

Moreover, the arguments of petitioner and amicus about the unfairness of injunctive relief ignore the equitable discretion of the district court to arrive at an "adjustment and reconciliation between the public interest and private needs * * *." *Hecht Co.* v. *Bowles*, *supra*, 321 U.S. at 329. The courts have discretion to refuse to issue an injunction that is not required under all the circumstances. For example, even though scienter is not an essential element of a statutory violation, a court may still consider that factor, as well as others, in determining whether to

issue an injunction. See pages 64-65, *supra*. The court may properly take into account

> the likelihood of future violations, the degree of scienter involved, the sincerity of defendant's assurances against future violations, the isolated or recurrent nature of the infraction, defendant's recognition of the wrongful nature of his conduct, and the likelihood, because of defendant's professional occupation, that future violations might occur.

SEC v. *Universal Major Industries Corp.*, *supra*, 546 F.2d at 1048. The inherent power of the district courts to "do equity" in particular cases provides substantial assurance against unfairness in decreeing injunctive relief.

4. Although petitioner argues (Br. 13-14) that the Commission should be denied authority to seek injunctive remedies against negligent deceptive practices because of collateral administrative sanctions flowing from an injunction, he fails to recognize that such collateral sanctions are separate from the injunctive remedy and are essentially discretionary in nature.

Certain categories of persons enjoined from engaging in securities fraud are subject to administrative sanctions if their conduct is such that the public interest requires additional protection. These persons are subject to special regulatory scrutiny because of the substantial sensitivity of their positions and the grave consequences to the public of their defaults. For example, a broker's registration may be suspended or revoked if he is subject to an injunction; a professional's privilege to practice before the Com-

mission may be suspended; and an issuer of securities is barred from utilizing certain exemptions from the registration requirements of the Securities Act.

But these collateral consequences are essentially discretionary. Under Section 15(b)(4) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4), for example, administrative sanctions against a broker may only be invoked after notice and a hearing and only if the Commission finds that such action is in the public interest. Similarly, under Rule 2(e)(3) of the Commission's Rules of Practice, 17 C.F.R. 201.2(e)(3), suspension of the right to practice before the Commission is only ordered when consistent with the "public interest," and the respondent may "show cause" why suspension is unnecessary. See also Section 203(e) of the Investment Advisers Act, 15 U.S.C. 80b-3(e). Section 9(c) of the Investment Company Act, 15 U.S.C. 80a-9(c), authorizes the Commission to modify sanctions that are imposed by that Act where they are unduly severe or not in the public interest. See also Rule 252(f) under the Securities Act, 17 C.F.R. 230.252(f). The subject of administrative sanctions has the right to show why the sanctions are unnecessary or inappropriate and to seek judicial review. See, *e.g.*, *Shuck* v. *SEC*, 264 F.2d 358, 362 (D.C. Cir. 1958) (when the Commission imposes sanctions on the basis of an injunction, "its action must be fair and just under all the circumstances, and lacking in any element of an arbitrary or capricious nature, as well as being in the public interest").

5. The Commission is the agency charged with administering the federal securities laws in the public interest. "A vigorous and effective enforcement program is critical to the Commission's ability to carry out its responsibility to protect investors." 1978 *Annual Report of the Securities and Exchange Commission* vi. The injunctive proceeding, as this Court noted in *Hochfelder*, is one of the important remedies in the "arsenal of flexible enforcement powers" granted to the Commission by Congress—powers vested in the Commission in recognition of the inadequacy of a "rigid statutory program" and the need for enforcement tools in addition to the "numerous carefully drawn express civil remedies and criminal penalties" in the federal securities laws. 425 U.S. at 195. Indeed, the injunction is the "basic tool provided the Commission for requiring compliance" with the securities laws.[41] Through an injunctive proceeding, the Commission, acting as a statutory guardian of the public interest,[42] brings "to the defendants' attention their past infraction[s] * * * and [lays] down a specific admonitory prescription to guide their future course." *United States* v. *Custer Channel*

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[41] *SEC* v. *IMC International, Inc.*, 384 F.Supp. 889, 894 (N.D. Tex.), aff'd without opinion, 505 F.2d 733 (5th Cir. 1974), cert. denied, 420 U.S. 930 (1975).

[42] The Commission sues not as an ordinary litigant but rather "as a statutory guardian charged with safeguarding the public interest * * * and 'the standards of the public interest, not the requirements of private litigation, measure the propriety and need for injunctive relief.'" *SEC* v. *Management Dynamics, Inc., supra*, 515 F.2d at 808, quoting *Hecht Co.* v. *Bowles, supra*, 321 U.S. at 331.

Wing Corp., 376 F.2d 675, 682 (4th Cir.), cert. denied, 389 U.S. 850 (1967).[43]

No consideration of fairness is violated by requiring persons who have engaged in deceptive conduct to be "more than normally careful in their behavior not to repeat the offense." *United States* v. *Custer Channel Wing Corp.*, *supra*, 376 F.2d at 682. When compared either to the damage inflicted on the public and the national economy by such deceptive conduct in securities transactions or to the effect of private damage remedies on a defendant who engages in deceptive behavior, the injunction is indeed a "mild prophylactic." *SEC v. Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 193.

Petitioner's contrary view, if accepted, would ultimately result in injury not only to investors but also

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[43] This Court has often noted the importance of preserving the flexibility and effectiveness of the government's injunctive remedies—"[where] the public interest is involved," the equitable powers of the district court "assume an even broader and more flexible character." *Porter* v. *Warner Holding Co.*, 328 U.S. 395, 398 (1946). See also *Hecht Co.* v. *Bowles*, *supra*, 321 U.S. at 329. "Courts of equity may, and frequently do, go much farther both to give and withhold relief in furtherance of the public interest than they are accustomed to go when only private interests are involved." *United States* v. *First National City Bank*, 379 U.S. 378, 383 (1965).

The Court's recent decisions restricting the availability of private "implied" remedies underscore the importance of regulating deceptive practices in the securities markets through governmental enforcement proceedings. In the absence of effective government enforcement of these statutes, the abuses that Congress determined to be causes of the stock market crash of 1929 will not be effectively restrained.

to the securities industry itself by undermining investor confidence in securities professionals and by providing a competitive advantage to those persons disposed to ignore professional standards in making securities recommendations. In these circumstances, the court of appeals was entirely correct in concluding that "the increased effectiveness of government enforcement actions predicated on a showing of negligence * * * outweigh[s] the danger of potential harm to those enjoined from violating the securities laws" (Pet. App. 15a).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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In the Supreme Court of the United States

OCTOBER TERM, 1979

PETER E. AARON, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION OF THE SECURITIES AND EXCHANGE COMMISSION FOR LEAVE TO FILE A SUPPLEMENTAL BRIEF

AND

SUPPLEMENTAL BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

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MOTION OF
THE SECURITIES AND EXCHANGE COMMISSION
FOR LEAVE TO FILE A SUPPLEMENTAL BRIEF

The Solicitor General, on behalf of the Securities and Exchange Commission, moves for leave to file the attached supplemental brief responding to certain arguments raised by the Securities Industry Association ("SIA") in its amicus curiae brief filed in support of petitioner.

The SIA submitted its amicus brief to this Court on January 9, 1980, the day on which the Commission's brief was filed and forty days after petitioner's brief was filed and the SIA's brief was due. The Commission did not consent to the filing of the SIA's brief because the Commission's brief was in page-proof form when counsel for the Commission first received a draft of the SIA's

brief. It was therefore impossible for the Commission to respond to the arguments raised by the SIA. The Court granted the SIA's motion to file its brief on January 21, 1980.

The SIA's brief purports to focus on "issues and authorities not covered in the other briefs" filed in this case in support of petitioner. Motion of the Securities Industry Association for Leave to File a Brief *Amicus Curiae* 3. Accordingly, the Commission seeks leave to file the attached supplemental brief to respond to certain arguments raised by the SIA that have not been raised by petitioner and other amici.

Respectfully submitted.

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SUPPLEMENTAL BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

1. The Securities Industry Association ("SIA") argues that use of the word "fraudulent" in the title of Section 17(a) limits all three subparagraphs of that provision to intentional misconduct (SIA Br. 14-16). The SIA further argues (*ibid.*) that the language of subparagraphs (1) and (3) of Section 17(a) require scienter and that, under the doctrine of *ejusdem generis*, subparagraph (2) should also be so limited.

However, the title of Section 17(a)—"Fraudulent Interstate Transactions"—cannot "take the place of" or "limit the plain meaning of the text" of the statute. *Brotherhood of Railroad Trainmen* v. *Baltimore & Ohio Railroad Co.*, 331 U.S. 519, 528-529 (1947). Moreover, the use of the word "fraudulent" does not imply a

congressional intent to require scienter in an injunctive proceeding. As discussed at length in our initial brief (Br. 23-35), the word "fraud" has a broader meaning in equity than at law, and the word does not require proof of scienter in this context. See *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 192-195 (1963).[1]

The SIA's *ejusdem generis* argument concerning the three subparagraphs of Section 17(a) is foreclosed by *United States* v. *Naftalin*, 441 U.S. 768, 773-774 (1979), which held that each subparagraph of Section 17(a) is intended to proscribe a "distinct category of misconduct." The Court explained in *Naftalin* that limitations on one subparagraph of Section 17(a) are not intended "to narrow the reach" of the others.

Finally, as we noted in our initial brief (Br. 30-35, 37-38 & n.17), nothing in the language of subparagraph (3) of Section 17(a) suggests a scienter requirement.[2] *Capital Gains*, which considered substantially identical language, is dispositive of SIA's contrary argument. Nor should scienter be required under subparagraph (1), because Congress considered and rejected a scienter requirement under that provision.[3]

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[1]New York's Martin Act was entitled "Fraudulent Practices in Respect to Stocks, Bonds and other Securities." N.Y. Gen. Bus. Law §§ 352-353 (Consol. 1921). As noted in our initial brief (Br. 28), this provision—which served as a model for Section 17(a)—was never interpreted to require scienter.

[2]Contrary to the SIA's assertion (Br. 15), *Steadman* v. *SEC*, 603 F. 2d 1126, 1133 (5th Cir. 1979), held that (emphasis supplied): "scienter need not be proved to establish violations of subsections 17(a)(2) *and* (3)."

[3]In several proposed versions of Section 17(a), the phrase "with the intent to defraud" would have applied to (and *only* to) the clause that became subparagraph (1). See our initial brief at pages 40-41 & n. 20; S. 875, 73d Cong., 1st Sess. §13 (Apr. 14, 1933) (Confidential Committee Print No. 2); S. 875, 73d Cong., 1st Sess. §13 (Apr. 18, 1933) (Confidential Committee Print No. 3); S. 875, 73d Cong., 1st Sess. §13 (Apr. 26, 1933) (Confidential Committee Print No. 4). In addition to eliminating this language, Congress eliminated the word "willfully," which would have imposed a state of mind requirement under subparagraph (1). See our initial brief at pages 39-42.

2. The SIA also argues (Br. 16-18) that Congress' rejection of the words "willfully" and "intent to defraud" in drafting Section 17(a) is not significant. It is true that the Conference Committee that adopted the House version of Section 17(a) did not explain its reasons for eliminating these words (which appeared in the Senate version of Section 17(a)). But that hardly suggests that the elimination was inadvertent.

The House bill, which as reported did not include the words "willfully" and "intent to defraud," was used by the conferees as their working draft. The Senate bill was rarely mentioned in conference discussions. See Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 39, 45 (1959). The House version of Section 17(a) was not amended by the Conference Committee and thus did not require discussion.[4] Moreover, the Conference Report did not undertake to discuss all of the "[n]umerous differences between the House Bill and the Senate amendment * * * about the powers of the * * * Commission." H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 27 (1933).

The conferees knew full well that their decision to delete the words "willfully" and "intent to defraud" was

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[4]As the SIA notes (Br. 18), the Conference Report purports to discuss the "differences between the House bill and *the substitute agreed upon by the conferees*" (emphasis supplied). It does not purport to discuss every element of the *Senate* bill that was rejected.

significant. The subject of "willfulness" received "extended discussion by the Congressional Committees" when criminal prosecutions under the Securities Act were considered (see Herlands, *Criminal Law Aspects of the Securities Act of 1933*, 67 U. S. L. Rev. 562, 565 (1933); see also *id.* at 565-567 n. 7). The conferees were well aware that the word "willfully" would impose a state of mind requirement. See 77 Cong. Rec. 2994 (1933) (remarks of Sen. Fletcher); 77 Cong. Rec. 2919 (1933) (remarks of Rep. Rayburn). And the phrase "intent to defraud," which also was rejected in conference, plainly would have required scienter in an injunctive proceeding. Under these circumstances, creation of a scienter requirement under Section 17(a) by judicial interpretation would result in the imposition of the very standard that Congress deliberately omitted.

The SIA also claims (Br. 16-17) that scienter should be required because the House Report states that Section 17(a) prohibits "any device, scheme, or artifice to defraud." The .SIA contends that this is the only legislative history discussing the scope of Section 17(a).[5] However, the House Report was merely reciting the statutory language of one subparagraph of Section 17(a). The Report later discusses the coverage of Section 17(a) by referring comprehensively to all three of its subparagraphs. H.R. Rep. No. 85, 73d Cong., 1st Sess. 24 (1933).

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[5] *Federal Securities Act: Hearing on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 109 (1933) (noting that Section 17(a) is similar to New York's Martin Act); *id.* at 240-241 (remarks of Judge Healy) (suggesting that the power granted under Section 17(a) to enjoin "fraud or misrepresentation" be transferred from the Attorney General to the Commission).

3. The SIA argues from the structure of the securities laws (Br. 19) that Congress has expressly indicated the situations in which liability may be based on negligence.[6] This structure, in the SIA's view, supports the argument that negligent deception cannot be enjoined under Sections 17(a) and 20(b) of the Securities Act. But this contention ignores the fact that, throughout the securities laws, Congress has generally authorized the Commission to seek injunctive relief without imposing any culpability requirement. Congress has relied instead on the traditional discretionary powers of courts of equity to determine when relief is appropriate.[7]

4. The SIA also argues (Br. 24-26) that permitting injunctive remedies under Section 17(a) of the Securities Act and Section 10(b) of the Securities Exchange Act without proof of scienter would defeat the requirements of Section 15(b)(4) of the Securities Exchange Act, 15 U.S.C. 78*o*(b)(4), by permitting the imposition of administrative sanctions without a showing of "willfulness." However, Section 15(b)(4) allows the Commission to impose sanctions (when consistent with

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[6] The SIA premises its comparative analysis on *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 200 (1976). But *Hochfelder* sought to harmonize implied and express *damage* remedies. Here, by contrast, the SIA seeks to equate statutory provisions authorizing injunctions with other statutory provisions authorizing private damage remedies and administrative relief. This is not a fruitful comparison. As noted in our initial brief (Br. 23-25), the law historically has drawn a sharp distinction between injunctive relief and money damage remedies.

[7] The Commission's argument does not, as the SIA asserts (Br. 16), lead to liability for wholly faultless conduct. Courts have granted injunctive relief only when it is anticipated that misconduct is likely to recur. The degree of culpability is one of many factors to be considered in making this determination. See our initial brief at pages 64-65, 74-75.

the public interest) when a broker or dealer commits violations "willfully" (Section 15(b)(4)(D)) *or* when the broker or dealer has been "permanently or temporarily enjoined * * * from engaging in or continuing any conduct or practice in connection with * * * the purchase or sale of any security" (Section 15(b)(4)(C)). "Willfulness" is not an express requirement under subparagraph (C) and should not be made a requirement by implication. *Shuck* v. *SEC*, 264 F. 2d 358, 361-362 (D.C. Cir. 1958). The SIA's contrary interpretation would make subparagraph (C) superfluous, because willful violations of the law can serve as the basis for sanctions even when no injunction has been issued. See *id.* at 362.[8]

We also note that Section 15(b) was not added to the Securities Exchange Act until 1936. There is no evidence that Congress intended at that time to narrow the scope of the injunctive remedies previously provided under the Securities Act and the Securities Exchange Act. See our initial brief at page 72 & n.40. See also *United States* v. *Naftalin*, *supra*, 441 U.S. at 777 n.8 ("subsequent enactments do not serve to restrict the original scope of §17(a)").

Nor is there merit to the SIA's assertion (Br. 24-25) that severe sanctions will be imposed under Section 15(b)(4) on the basis of an injunction alone when the circumstances do not require such administrative action. As discussed in our initial brief (Br. 76), the Commission

[8]The SIA suggests (Br. 25 n.4), without citation of supporting authority, that Congress in enacting Section 15(b)(4)(C) did not intend the issuance of an injunction to serve as an "alternative standard of liability" but only intended to avoid the necessity of relitigating issues resolved in an injunctive proceeding. This suggestion is without merit because a defendant is collaterally estopped from relitigating findings of fact made in connection with the entry of a permanent injunction.

cannot impose a sanction unless it finds after a hearing that the sanction is "in the public interest." This is true even if the defendant broker-dealer has already been enjoined from engaging in deceptive securities practices. There is no reason to assume that the Commission will refuse to consider all relevant factors, including the degree of the defendant's culpability, before making such a determination. Should the Commission act arbitrarily, such administrative action would not withstand judicial review.

5. The SIA contends (Br. 29, 31) that the business of a broker-dealer is based on trust and confidence and that an injunction resulting from negligent deception of customers could "mar[ ] the record and reputation of a broker-dealer." But in such circumstances, when the broker-dealer's negligence has misled customers and there is a cognizable danger of repetition of deception, it is not the Commission's action that threatens the defendant's reputation. The trust that investors place in fiduciaries such as brokers is hardly a reason for eliminating the requirement that they act with reasonable care or for disregarding negligent deception. As noted in our initial brief (Br. 69-72), careless and imprudent conduct of securities dealers contributed to the market crash of 1929. History teaches that investor confidence is essential to the vigor of the national securities markets and that investors need protection from broker-dealers who mislead their clients through negligent behavior.

The SIA also argues (Br. 6, 29, 31-32) that application of a negligence standard under Sections 17(a) and 10(b) would result in a "proliferation of SEC injunction actions" and adverse collateral consequences for broker-dealers. But collateral consequences are not a reason for permitting negligent broker-dealers to continue to

deceive investors. Moreover, as we have previously noted (Br. 38-39 n.17, 48, 68-69), the courts of appeals have long applied a negligence standard in injunctive actions under both Sections 17(a) and 10(b). Brokers can also be required to exercise due care under other provisions of the securities laws. See Section 9(a)(4) of the Securities Exchange Act, 15 U.S.C. 78i(a)(4) (prohibiting negligent misrepresentations by brokers or dealers who recommend securities transactions on exchanges); Section 15(c)(2) of the Securities Exchange Act, 15 U.S.C. 78*o*(c)(2) (empowering the Commission to adopt rules to forbid acts in the over-the-counter market that are conducive to fraud even though such acts are not themselves fraudulent). See also *Regulation of Over-the-Counter-Markets: Hearings on S. 3255, H.R. 9634, Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 75th Cong., 3d Sess. 38-41, 50, 54-55 (1938).

In sum, the negligence standard applicable in injunctive actions under Sections 17(a) and 10(b) does not impose novel requirements. It imposes duties that are comparable to those imposed by other related provisions of the securities laws.

6. The SIA also argues (Br. 33-40) that this Court should give the lower federal courts guidance on the scope of injunctive remedies. It contends that the Court should prescribe requirements for injunctive relief in addition to the finding of a substantive violation of the securities laws (Br. 34)[9] and that it should expound upon

[9]The SIA claims (Br. 35) that "Congress has repeatedly rejected attempts by the Commission to expand its powers * * * to file for injunctions upon the basis of past misconduct alone" and suggests that the Court should instruct the lower courts that an injunction should not issue solely on that basis. But there is no need for such instruction. The lower courts do not automatically grant injunctions simply because of past violations of the securities laws. See Pet. App. 45a.

Moreover, despite the SIA's suggestion that there have been unsuccessful attempts to alter the standards for injunctive relief through legislation, Congress rejected the proposed legislation, not because it would have expanded, but rather because it would have merely restated, existing law. In 1960 and 1975, Congress found such proposed legislation to be unnecessary, expressing its agreement with the long-standing judicial interpretation of the "present statutory language" that permits a court, in the exercise of its "historic equity discretion," to consider evidence of past violations as showing the "existence of some cognizable danger of recurrent violation." S. Rep. No. 1756, 86th Cong., 2d Sess. 4 (1960). See also H.R. Rep. No. 94-229, 94th Cong., 1st Sess. 102 (1975) ("existing law does not require clarification in these respects"); S. Rep. No. 1757, 86th Cong., 2d Sess. 9 (1960); H.R. Rep. No. 2180, 86th Cong., 2d Sess. 5 (1960).

[10]Although the SIA argues that injunctive orders should not track the language of the statutory provision involved, petitioner has not raised this objection here or in the lower courts. The only difference between the injunction issued and the injunction proposed by petitioner is the inclusion of the words "or any other securities." See SIA Br. 37. The SIA's objection (Br. 8) to that language is without merit. "A federal court has broad power to restrain acts which are of the same type or class as unlawful acts which the court has found to have been committed or whose commission in the future, unless enjoined, may fairly be anticipated from the defendant's conduct in the past." *NLRB* v. *Express Publishing Co.*, 312 U.S. 426, 435 (1941). An injunction limited to a particular security would be "so narrow as to invite easy evasion." *McComb* v. *Jacksonville Paper Co.*, 336 U.S. 187, 193 (1949).

the proper form of injunctive orders (*id.* at 37-40).[10] However, these questions were not encompassed by the grant of certiorari in the present case and are unrelated to the questions briefed by the parties. Under these circumstances, the Court need not address the issues that the SIA belatedly seeks to interject.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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FOR ARGUMENT

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IN THE

Supreme Court of the United States

October Term, 1979

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PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONERS

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REPLY BRIEF FOR PETITIONERS

The SEC in its brief contends that this court's decision in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 does not extend to SEC injunction actions primarily for three reasons: (1) established equity practice prior to the enactment of the 1933 and 1934 Acts, (2) the precedents under the New York State Blue Sky Law—the Martin Act and (3) the Court's decision holding in *Capital Gains.* None of these arguments will withstand analysis.

A. The SEC in its brief—to support a differentiation between the required elements of an SEC injunction action, as distinguished from a civil damage claim under the anti-fraud provisions of the 1933 and 1934 Acts—points to established principles of equity "providing relief for de-

frauded plaintiffs without proof of scienter," citing, among other authorities, the House of Lords' decision in *Derry* v. *Peck,* 14 App. Case 337 (1889), which at 359 (the page cited by the SEC), states that

> "Where rescission is claimed, it is only necessary to prove that there was misrepresentation; then, however honestly it may have been made, however free from blame the person who made it, the contract, having been obtained by misrepresentation, cannot stand."*

The SEC slights over the fact that relief granted under such principles of equity was the rescission of a single individual transaction. Equitable relief in such circumstances was designed so as to prevent the seller from profiting from a misrepresentation, however innocent, regarding the property which he sold.

This principle of equity was designed to do justice between the parties to a single transaction. It is clearly different from the broad injunctive power asserted by the Commission under the 1933 and 1934 Acts against any violations of the generalized catch-all, antifraud provisions of Section 17 and Rule 10b-5. The only consequence of the rescission of a transaction is the loss of a particular deal in accordance with equitable principles only loosely described as "equitable fraud."** In contrast, an injunction in

* Similarly, *Smith* v. *Richards,* 38 U.S. 26 (1839), cited by the SEC Br. 25, states that for purposes of a rescission action "even if the party innocently misrepresents a fact by mistake, it is equally conclusive."

** Innocent or negligent misrepresentations giving rise to equitable claims for rescission are not commonly referred to as, and are distinguished from, fraud. For example, the New York Court of Appeals in *Bloomquist* v. *Farson,* 118 N.E. 855, 856 (1918), ruled that "an action may be maintained in equity to rescind a transaction

(footnote continued on following page)

SEC actions subjects defendant to the potent weapon of the court's contempt powers, to publicity potentially destructive of its business and to grave collateral consequences, including in the case of a broker-dealer, exclusion from the securities business.

In case of rescission, equity acts against a blameless person because between the seller and the buyer it is more equitable to relieve the buyer from the contract which he entered on the basis of an innocent misrepresentation. It does not try to assign or fix blame or fault. In contrast, an injunction under the 1933 and 1934 Acts is issued against a defendant because he is violating, or has the propensity to violate, the law. It judges the defendant culpable and tags him as being guilty of, and/or prone to, "fraud."

B. The SEC in its brief also places reliance on the judicial interpretation of the Martin Act (N.Y. Gen. Bus. Law §§ 352-353 consol. 1921) in *People* v. *Federated Radio Corporation,* 244 N.Y. 33, 154 N.E. 655 (1926). The Martin Act was a New York State statute which prohibited in general terms fraudulent conduct and misrepresentation in connection with the sale of securities. It made such conduct subject both to criminal penalties and injunctive relief. The Martin Act was limited to general antifraud provisions and it did not, as did the 1933 Act, establish a comprehensive

(footnote continued from preceding page)

which has been consummated through misrepresentation of material facts *not* amounting to fraud." Similar, the Restatement of Torts (1938) clearly distinguishes between "fraudulent misrepresentations" in § 525 *et seq.* and "negligent misrepresentations in § 552. The SEC quotation from *Smith* v. *Richards* (Br. 25) referring to "a false representation, whether knowingly or not" as a "fraud" is contrary to general legal usage and not necessary for the decision in that case. Moreover, it is inconsistent with the language of p. 38 of the same opinion stating "it is immaterial to the purchaser whether the misrepresentation proceeded from fraud or mistake. The injury to him is the same, whatever the motives of the seller."

scheme for the registration of securities and the imposition of liabilities.

Federated Radio involved false statements in a prospectus, and the court's decision there was grounded on the then established principle that "promoters are under a duty to make reasonable investigation before issuing a prospectus." The court ruled therefore that "to the extent that they fail in the performance of their duty, lack of scienter will not relieve them from liability in actions brought under the Martin Act." The court specifically reserved the decision on "whether a like duty attaches to persons not promoters." In *Federated Radio* the court expanded the Martin Act to cover an obvious and well established evil—misrepresentations in prospectuses—against which there were no specific prohibitions or remedies.

Congress, in enacting the Securities Act of 1933, specifically rejected proposals simply to adopt an antifraud statute similar to the Martin Act and instead, adopted a statute which dealt explicitly with the problem of negligent misrepresentations in prospectuses, imposing an absolute liability on issuers and a duty of reasonable investigation or care on directors and experts.

C. The SEC, to avoid the plain thrust and meaning of the *Hochfelder* decision, places its reliance instead on this Court's earlier decision in *SEC* v. *Capital Gains,* 375 U.S. 180 (1963). In that case, the Court upheld a preliminary injunction issued under the Investment Advisors Act" requiring a fiduciary to disclose to his client, not all his security holdings, but only his holdings in recommended securities just before and after the issuance of his recommendations."

The Court held that for purposes of issuing a preliminary injunction under this Act, "Congress did not intend to require proof of intent to injure or actual injury to the

client." The Court's opinion in that case is heavily premised upon the legislative history of Section 206, and the "delicate fiduciary nature of an investment advisory relationship." Here, however, the antifraud provisions of the 1933 and 1934 Acts, as broadly construed by the courts, regulate a myriad of commercial transactions which are not of a fiduciary nature. Section 10(b) of the 1934 Act is a " 'catch-all clause, to prevent manipulative devices' ", (*Hochfelder* at 202) and Section 17(a) deals generally with "Fraudulent Interstate Transactions." The law has always attached more stringent obligations on fiduciaries. In the absence of special fiduciary obligation, the threshold for using the tool of injunctive relief is appropriately set higher.

In addition, the SEC revels in Justice Goldberg's characterization in *Capital Gains* of an injunctive as a "mild prophylatic"—a term quoted from the Second Circuit's dissenting opinion in *Capital Gains.* However, as Judge Friendly recently stated in *SEC* v. *Commonwealth Chemical Securities,* 574 F.2d 90, 99 (2d Cir. 1978) "experience has shown that an injunction often is much more than a 'mild prophylatic.' In some cases, the collateral consequences of an injunction can be very grave." The experience referred to by Judge Friendly makes clearly outmoded any further reliance on the "mild prophylatic" nature of injunctive relief. Injunctive relief under the antifraud provision, recognized now as a weighty remedy, must be reserved for cases of intentional or reckless conduct. It was not intended and should not be construed as being a remedy against mere negligence.

D. The SEC, to bolster its tenuous legal arguments, makes a plea on policy grounds. It states that "if deception stemming from carelessness is not prohibited by these statutory provisions, the economic interests of participants in securities markets would be seriously impaired." As this

Court stated in *Hochfelder,* where the "language and history are dispositive," there is no occasion to examine the additional considerations of "policy." See also, *Touche Ross & Co.* v. *Redington,* 99 S.Ct. 2479 (June 8, 1979).

In any event, Congress did provide a considerable arsenal against careless misrepresentations. Among other things, it provided for stop-order proceedings to prevent the use of registration statements containing such misrepresentations and in the 1934 Act, Section 15(c)(4) provided for administrative orders requiring the correction of false reports filed with the Commission. Further, it imposed civil liabilities for innocent and/or negligent misrepresentations in registration statements.

If the remedies Congress has provided are not sufficient to deal with careless misrepresentations, the SEC should ask Congress for additional remedies especially structured to attack this problem rather than to ask this Court to construe the antifraud provisions to cover conduct not comprehended by the language or intent of these provisions.

E. The Second Circuit Court of Appeals found "it unnecessary to reach the question whether Aaron's conduct would support a finding of scienter (A13-A14)." Petitioner respectfully suggests that the Court did so because there was substantial evidence that his conduct was negligent and not intentional.

The trial record reveals that on just two separate occasions, several months apart, was petitioner made aware that misrepresentations were being made by other employees of E. L. Aaron & Co. In each instance, petitioner telephoned the branch office where those employees worked, informed them of the nature of the complaints, and requested that they discuss the matter with Lawn-A-Mat's attorney (182-183, 274-276, 426, 428, 519).*

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* Refers to the original trial transcript.

In light of this Court's decision in *Hochfelder,* the opinion of the Court of Appeals for the Second Circuit should be reversed and the cause remanded for further proceedings to decide whether petitioner's conduct would support a finding of scienter.

Respectfully submitted,

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IN THE

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OCTOBER TERM, 1979

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PETER E. AARON,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

BRIEF OF MID-AMERICA LEGAL FOUNDATION AS AMICUS CURIAE

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BRIEF OF MID-AMERICA LEGAL FOUNDATION AS AMICUS CURIAE

INTEREST OF AMICUS

This *amicus curiae* brief is submitted on behalf of Mid-America Legal Foundation (*"Mid-America"*) with the consent of both parties being filed with the Clerk of the Court.

Mid-America was organized in 1975 as an Illinois not-for-profit corporation to engage in non-partisan legal research, study and analysis for the benefit of the general public as to evolving concepts of law on our democratic institutions. *Mid-*

America has an interest in this case because the opinion below interprets Section 17(a) of the Securities Act of 1933 (the "1933 Act") and Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act") in a way which has far reaching ramifications on enforcement actions by the Securities and Exchange Commission (the "Commission") and every other governmental agency.

The Court below effectively imposed a dual legal standard wherein an individual's culpability under the same law is measured solely by the identity of the party bringing the action and not by the statutory language or the challenged conduct. Thus, conduct which is legitimate as to an injured private party may nevertheless support injunctive relief in an action by the Commission under the identical statute.

Despite the extraordinary nature of equitable relief, the decision below granted the Commission an injunction merely upon a showing that the defendant was conscious during a past failure to restrain conduct by others which was later shown to have violated the law. In the absence of evidence that further violations are reasonably expected, however, injunctive relief is clearly inappropriate. The court of appeals ignores the fact that one acting in good faith or without scienter, who is later apprised that certain action or inaction was illegal, is no more likely to continue than any other member of the general public. *See, e.g. SEC* v. *Koracorp Industries,* 575 F.2d 692, 698-699 (9th Cir.), *cert. denied,* 439 U.S. 953 (1978). Yet under these circumstances the court below would impose extraordinary sanctions absent any showing of scienter or bad faith or that the party charged ought to have known that his inaction violated the law.

This dual legal standard results in a quagmire of uncertainty for anyone engaged in investment activity or for that matter anyone subject to government regulation. There simply is no precise norm by which to gauge compliance with the law.

ARGUMENT

1. Scienter must be established by the SEC in an action to enjoin violations of § 17(a)(1) of the 1933 Act and § 10(b) of the 1934 Act.

This Court's decision in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976) construed the specific language of § 10(b) of the 1934 Act to include a scienter requirement. Despite that controlling interpretation, the court of appeals found it unnecessary to reach the question whether petitioner's conduct would support a finding of scienter. The lower court concluded that the scienter requirement was inapplicable to government enforcement proceedings to enjoin violations of sections 17(a) of the 1933 Act and 10(b) of the 1934 Act. (Pet. Cert. App. pp. 13a-14a).

The court of appeals attempted to distinguish the present case from *Hochfelder* and the language of § 17(a) from that of § 10(b). In so doing the court ignored important and controlling similarities, and misapplied this Court's holding on the scienter requirement. Although the lower court acknowledged that at least for purposes of § 10(b) the language of the statute at issue here and in *Hochfelder* is the same, it conducted a further unnecessary inquiry into the legislative history of the statute and arrived at a contrary conclusion. In pursuing this inquiry the court of appeals ignored this Court's conclusion in *Hochfelder* that the language of § 10(b) imposes a scienter requirement even though the language of subsection (b) of Rule 10b-5 and, arguably, subsection (c) may not require scienter. The lower court's journey into legislative history for § 10(b) and § 17(a)(1) was simply superfluous. It is a fundamental principle of statutory construction—clear and express wording of the statute is the primary means of determining legislative intent. *See, United States* v. *Oregon,* 366 U.S. 643, 648 (1961); *Packard Motor Car Co.* v. *NLRB,* 330 U.S. 485, 492 (1947).

More specifically, in *Hochfelder* this Court concluded that "the words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." 425 U.S. at 197. This conclusion was reinforced further through an admittedly unnecessary review of legislative and regulatory history. 425 U.S. at 201-206.

Hochfelder involved a private claim for damages under § 10(b) and Rule 10b-5. This remedy was not derived from express terms of the statute or the regulation but rather had been implied by lower courts over years of litigation. There is no evidence that either Congress or the Commission contemplated private remedies for violations of these provisions when they were originally enacted. 425 U.S. at 196. Thus, at least initially, the scienter requirement established in *Hochfelder* would have applied only to Commission actions. To conclude that after a private civil remedy has been implied the statute's substantive meaning changed for Commission enforcement proceedings, however, strains the limits of the *Hochfelder* ruling. The identity of the plaintiff provides no basis in fact, in logic or in law for varying the legal standard under the same statutory and regulatory language once that standard has been defined by this Court.

This is not to say that every section of the securities acts employs the same legal standard. *Hochfelder* clearly recognized that private plaintiffs were not required to prove scienter in every action under these Acts. 425 U.S. at 207-208. This Court also carefully noted in *Hochfelder* that the Commission quite likely would not be required to show scienter under subsection (b) of Rule 10b-5, 425 U.S. at 212, which corresponds to § 17(a)(2) or, arguably, under subsection (c) of the Rule which corresponds with § 17(a)(3). *Id.* Indeed the primary teaching of *Hochfelder* is that where the language of the statute clearly imposes a requirement of scienter or intent the agency cannot avoid this standard by regulation—not for

the benefit of injured parties in private suits and not for the benefit of the general public in suits by the Commission. The touchstone is the intent of Congress and not the desirability of the remedy.

The court of appeals, citing its earlier decision in *SEC* v. *Coven*, 581 F.2d 1020, 1026-1027 (2d Cir. 1978), *cert. denied*, ____U.S.____, 99 S.Ct. 1439 (1979) distinguished the wording of § 17(a) from that of § 10(b) and concluded that the former lacked language comparable to that in § 10(b) which this Court found persuasive in *Hochfelder*. (Pet. Cert. App. at 19a).

This conclusion ignores several important aspects of the relationship between § 17(a), § 10(b) and Rule 10b-5. First and most importantly, the language of Rule 10b-5 (a) utilizes the language of § 17(a)(1) and closely parallels the language of § 10(b) which under the *Hochfelder* analysis specifically required scienter. And there the similarity ends. Subsections (2) and (3) of § 17(a) parallel subsections (a) and (b) of Rule 10b-5. Each contains language which, standing alone, might encompass both negligent and intentional behavior, 425 U.S. at 212. However, only § 17(a)(1) is applicable to the facts in the case at bar.

Section 17(a)(2) and (3) could apply in this case only if petitioner conspired in or willfully aided and abetted the conduct proscribed by these provisions. While the record is replete with findings of petitioner's failure to act, it is noticeably lacking in any findings of affirmative action by the petitioner that aided and abetted the misrepresentation.

There simply is no authority to support liability for willfully aiding and abetting without a showing of some culpability on the defendant's part. Inaction alone will not suffice unless the duty to act is clear. *Hochfelder* v. *Midwest Stock Exchange*, 503 F.2d 364, 374 (7th Cir. 1974), *cert. denied*, 419 U.S. 875 (1974).

This Court's discussion in *Hochfelder* of the lack of uniformity in standards of culpability coupled with the many procedural safeguards 425 U.S. at 207-209, reinforces the necessity of evaluating such standards on the basis of statutory construction, not on the identity of the plaintiff bringing the action.

2. A willful violation of the law requires far more than an unwitting or innocent act.

An injunction is an extraordinary form of relief. Its purpose is to cause or prevent specified conduct but its necessity is derived from the very purposefulness of the conduct otherwise likely to occur. *SEC* v. *Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1245 (S.D. N.Y. 1976), *aff'd on other grounds*, 565 F.2d 8 (2d Cir. 1977). Although an injunction ostensibly operates to restrain not to punish, in practical effect it oftentimes functions as a punitive measure and is so regarded in the investment community.

Thus, the subject enforcement proceeding for prospective injunctive relief to sanction a prior violation of the law wherein the willfulness or intention to violate the law was based on merely voluntary action or inaction without scienter is clearly inappropriate. An individual whose conduct inadvertently aided and abetted the illegal actions of others is no more likely to persist in that conduct once apprised of its unlawfulness, than any other member of the general public.

Moreover, in *United States* v. *Murdock*, 290 U.S. 389 (1933), this Court in rejecting the assertion that willfully "means no more than voluntary," stated:

> "The word [willfully] often denotes an act which is intentional, or knowing, or voluntary, as distinguished from accidental. But when used in a criminal statute it generally means an act done with a bad purpose; without justifiable excuse; stubbornly, obstinately, perversely. The word is also employed to characterize a thing done without ground for believing it is lawful, or conduct marked by careless disregard whether or not one has the right so to act." 290 U.S. at 394-95 (citations omitted).

Thus, a willful violation requires that the actor either knew or ought to have known of the law and the offense. *Spies* v. *United States*, 317 U.S. 492, 497-98 (1943); *Screws* v. *United States*, 325 U.S. 91, 101-103 (1945); and *United States* v. *Bishop*, 412 U.S. 346, 352, 361 (1973) are to the same effect.

Recently, this Court summarized that willfullness entails "a voluntary, intentional violation of a known legal duty." *United States* v. *Pompanino*, 429 U.S. 10, 12 (1976). Needless to say, one's legal duty ordinarily includes only the duty to use reasonable care to know and comply with the applicable law. Absolute liability is the rare exception not the rule.

Willful violation of the securities laws has long been regarded as "something far different from an unwitting or innocent violation." Hearings on Stock Exchange Practices Before Senate Committee on Banking & Currency, 73d Cong., 2d Sess. 6967 (1934); 2 Loss, Securities Regulation 1311 n.98. (2d Ed. 1961).

In the case at bar, petitioner was apprised by a third party that allegations of misconduct had been made against two of his firm's salesmen. He in turn informed the representatives of these same allegations. From these facts the lower court concluded that petitioner willfully aided and abetted their violation of the securities law because he failed to stop the misrepresentations. This conclusion ignores the important fact that petitioner's knowledge went only to allegations of misconduct not to specific violations of the law and certainly not to what further acts he was required to undertake to establish past violations, if any, or to prevent future violations.

For the future, willful violation might be found in similar circumstances based upon careless disregard for the inter-

pretative guidance of the Commission thereby necessitating an enforcement proceeding for injunctive relief. But the petitioner did not have the benefit of any such guidance at the time he acted. He had the benefit only of allegations of misconduct. He did not fail to act. He did discuss the allegations with the accused. There was no showing that he had reason to act further on the basis of allegations of misconduct merely because there was a potential for further abuse. The Commission's position suggests, without stating, the outrageous proposition that petitioner should have fired the salesmen on the basis of mere allegation under penalty of being an absolute guarantor of their future conduct.

> "A requirement that an offense be committed willfully is satisfied if a person acts knowingly with respect to the material elements of the offense, unless a purpose to impose further requirements plainly appears." Model Penal Code, § 2.02(8), Comment at 130, ¶ 10 (1962).

On the record before this Court, petitioner did not act knowingly with respect to the material elements of the offense. Injunctive relief was improper.

CONCLUSION

For the aforegoing reasons, the judgment and opinion of the United States Court of Appeals for the Second Circuit should be reversed.

Respectfully submitted,

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[1] We wish to acknowledge the assitance of Lewis Hu, a law student at DePaul University College of Law.

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IN THE

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Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

BRIEF *AMICUS CURIAE*

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MOTION OF AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE*

The American Institute of Certified Public Accountants (the "Institute") hereby respectfully moves, pursuant to Rule 42(3) of the Rules of this Court, for leave to file the attached brief *amicus curiae* in order to present its views as to the standards properly governing the issuance of an injunction against violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) ("§ 10(b)"), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979) ("Rule 10b-5"). The Institute submits that the Court of Appeals for the Second Circuit erred in its formulation of these standards and contends

that the judgment of that Court should be reversed and the cause remanded for further proceedings.[1]

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 150,000 members. Among its purposes are the promotion and maintenance of high professional standards of practice, and, in pursuit of those purposes, the Institute has come to be accepted as the authoritative source of standards and procedures in its field.

Accountants engaged in professional activities for regulated issuers are, of course, subject to SEC enforcement of § 10(b) and Rule 10b-5. The consequences to such professionals resulting from the issuance of injunctions against them at the instance of the SEC under the rubric of § 10(b) or Rule 10b-5 can be very serious indeed. The Institute accordingly has an important interest in the standards of culpability which must be established by the SEC in order to bring and sustain an injunction action under § 10(b) and Rule 10b-5 and the circumstances under which an injunction can issue for violations of these provisions. In related matters, the Institute was invited to and did testify before the United States Senate concerning the scope of the 1934 Act (*Hearings on S. Res. 84* (72d Cong.) *and S. Res. 56 and S. Res. 97 Before the Committee on Banking and Currency of the United States Senate,* 73d Cong., 1st Sess., pt. 15 at 7207-10 (1934))and was granted leave by this Court to file a brief *amicus curiae* in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976).

The Court of Appeals in this case held that *scienter* is not an essential element of a § 10(b) and Rule 10b-5 injunction action and that proof of negligence will in such actions suffice to establish a violation of that statute and rule. That broad holding appears to be contrary to the rationale of this Court's holding in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), and has serious implications for professionals who service regulated persons.

1. Petitioner has consented to the filing of this brief; respondent's consent has been requested but no response has yet been received.

The case as presented involves as defendants only persons who are directly involved in the securities business. The Court of Appeals simply had no occasion to consider the ramifications for professionals whose relationship to the securities business is ancillary, including accountants, of its view that negligence alone will suffice to warrant injunctive relief under § 10(b). The application of the holding below may, in many cases, result in subjecting accountants, who have been found to have violated § 10(b) on the basis of negligent conduct, and against whom injunctions have issued, to harsh and unwarranted consequences including severe and irreparable damage to their reputations and destruction of their ability to practice their profession. For these reasons, this case transcends the interests of the parties litigant and is of profound significance to the accounting profession.

The Institute will confine its brief *amicus curiae* to the following issue of major importance to the accounting profession as a whole:[2]

> May the SEC obtain an injunction pursuant to § 21 (d) of the Securities Exchange Act of 1934, 15 U.S.C.

2. The Petition also presents the issue of whether the SEC may obtain an injunction pursuant to § 20(b) of the Securities Act of 1933, 15 U.S.C. § 77t(b) (1976), restraining acts or practices in violation of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), in the absence of pleading and proof of defendant's *scienter.* The Institute has not formulated and does not express any position with respect to that issue.

§ 78u(d) (1976), restraining acts or practices in violation of § 10(b) of the 1934 Act and Rule 10b-5 in the absence of pleading and proof of the defendant's *scienter*?

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Preliminary Statement

The American Institute of Certified Public Accountants (the "Institute") submits this brief *amicus curiae* in order to present its views as to the standards properly governing the issuance of an injunction against violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976) ("§ 10(b)"), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979) ("Rule 10b-5"). The Institute submits that the Court of Appeals for the Second Circuit erred in its formulation of these standards and contends that the judgment of that Court should be reversed and the cause remanded for further proceedings.

Opinions Below

The opinion of the Court of Appeals (Anderson, Feinberg and Timbers, C.J.J.) affirming the decision of the District Court, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 (2d Cir. 1979), is not yet officially reported and is printed in the Appendix to the Petition for Certiorari. The Opinion of the District Court which granted the Securities and Exchange Commission ("SEC") a permanent injunction against petitioner Peter E. Aaron is reported at [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,043 (S.D.N.Y. 1977).

Question Presented

The Institute as *amicus curiae* addresses the following question presented in the Petition for Certiorari:[1]

> May the SEC obtain an injunction pursuant to § 21(d) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(d) (1976) ("§ 21(d)"), restraining acts or practices in violation of § 10(b) and of Rule 10b-5 in the absence of pleading and proving the defendant's *scienter*?

Additional Statute Involved

In addition to § 10(b) and Rule 10b-5 to which reference has been made in the Petition for Certiorari, there is involved § 21(d) of the Securities Exchange Act of 1934 which reads in relevant part as follows:

> Wherever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, . . . it may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United States courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. . . .

1. The Petition also presents the issue of whether the SEC may obtain an injunction pursuant to § 20(b) of the Securities Act of 1933, 15 U.S.C. § 77t(b) (1976), restraining acts or practices in violation of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), in the absence of pleading and proof of defendant's *scienter*. The Institute has not formulated and does not express any position with respect to that issue.

Interest of the Institute as *Amicus Curiae*

The Institute is the only national accounting association whose membership is limited to certified public accountants; it has approximately 150,000 members. Among its purposes are the promotion and maintenance of high professional standards of practice and, in pursuit of those purposes, the Institute has come to be accepted as the authoritative source of standards and procedures in its field.

Accountants engaged in professional activities on behalf of regulated persons are, of course, subject to SEC enforcement of § 10(b) and Rule 10b-5. The consequences to such professionals which may result from the issuance of injunctions against them at the instance of the SEC under the rubric of § 10(b) or Rule 10b-5 can be very serious indeed. The Institute accordingly has an obvious interest in the standards of culpability which must be established by the SEC in order to bring and sustain an injunction action under § 10(b) and Rule 10b-5 and the circumstances under which an injunction can issue for violations of these provisions. In related matters, the Institute was invited to and did testify before the United States Senate concerning

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The Court of Appeals held that *scienter* is not an essential element of a § 10(b) and Rule 10b-5 injunction action and that proof of negligence will in such actions suffice to establish a violation of that statute and rule. (Appendix to Petition for Writ of Certiorari, pp. 13a-14a.) That broad holding appears to be contrary to the rationale of this Court's holding in *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976). The case as presented here involves a defendant who is directly involved in the securities business. Nevertheless, the ramifications of the Court of Appeals' view of the necessary showing for injunctive relief extend to professionals whose relationship to the securities business is ancillary, including, most obviously, accountants. Thus, the application of the holding below may, in many cases, result in subjecting accountants, who have been found, on the basis of negligent conduct, to have violated § 10(b) and against whom injunctions have issued, to harsh and unwarranted consequences including severe and irreparable damage to their reputations and destruction of their ability to practice their profession. For these reasons, this case transcends the interests of the parties litigant and is of profound significance to the accounting profession.

Statement

Peter E. Aaron ("Aaron") was employed by E.L. Aaron & Co. ("Aaron & Co."), a broker-dealer registered with the SEC. In November 1974, Aaron & Co. opened a branch in Roslyn Heights, New York. Norman Schreiber, a registered representative of Aaron & Co., was appointed branch manager of the new office. Donald Jacobson, also an Aaron & Co. registered representative, was assigned to assist Schreiber.

From November 1974 through September 1975, Aaron & Co. made a market in the common stock of Lawn-A-Mat Chemical & Equipment Corp. ("LAM"). In promoting LAM's stock, Schreiber and Jacobson made false and misleading statements to prospective purchasers. When Schreiber and Jacobson continued making such statements despite warnings from LAM officers that such statements were false, LAM's attorney contacted Aaron and informed him that his sales representatives were making false and misleading statements. Aaron was in charge of the due diligence files for securities in which Aaron & Co. made markets. As a result, he had independent reason to know that the information about LAM being disseminated by Schreiber and Jacobson was untrue. Although Aaron notified Jacobson of the LAM attorney's complaint, he did nothing to stop the false and misleading statements being made by Schreiber and Jacobson.

The SEC commenced an enforcement action in the United States District Court for the Southern District of New York against Aaron and seven other defendants on February 26, 1976. It sought preliminary and final injunctive relief, pursuant to § 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976), and § 21(d) of the 1934 Act. The complaint charged, among

other things, that Aaron and the other defendants had violated, and aided and abetted violations of, § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1976), § 10(b) of the 1934 Act, and Rule 10b-5.[2]

With respect to the SEC's claim asserted against Aaron under § 10(b) and Rule 10b-5, the District Court stated:

> While negligence alone may suffice as a standard for liability in Commission enforcement proceedings, . . . the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws. [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,043 at 91,685.

The Court of Appeals concluded that it was unnecessary to consider whether Aaron's conduct would support a finding of *scienter,*

> since we hold that the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement actions brought under §§ 10(b) and 21-(d) of the 1934 Act. Consistent with the pre-*Hochfelder* decisions of this Court, we continue to hold that allegations and proof of negligence alone will suffice. . . . [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,128.

The SEC urged that Petitioner be granted a writ of Certiorari and on October 15, 1979, this Court granted Certiorari. 48 U.S.L.W. 3258 (No. 79-66).

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2. The complaint also charged Aaron and three other defendants with violating, and aiding and abetting violations of, the registration provisions of §§ 5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§ 77e(a) and 77e(c) (1976). The District Court held that Aaron had violated § 5 and the Court of Appeals affirmed this aspect of the District Court's opinion. The Petition for Certiorari does not appear to question the opinion of the Court of Appeals insofar as it held that there was a § 5 violation. For this reason, the facts relating to the § 5 claim are not summarized above.

ARGUMENT

The SEC is not entitled under § 21(d) of the 1934 Act to an injunction restraining acts or practices in violation of § 10(b) and Rule 10b-5 in the absence of a showing of *scienter*.

Summary

In *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185 (1976), this Court specifically left open "the question whether scienter is a necessary element in an action for injunctive relief under § 10(b) and Rule 10b-5." *Id.* at 194 n.12. The Institute submits that the Court should now conclude that *scienter* is a necessary element in such an injunction action.

That conclusion, the Institute submits, follows from the analysis required by the *Hochfelder* decision itself. The operative statutory language of § 10(b) points as unambiguously to the proscription of wilful conduct when injunctive relief is sought by the SEC as this Court found it did when damage relief was sought by a private plaintiff. Section 21(d), under which the SEC brings injunction actions for violations of § 10(b) and Rule 10b-5, in no way lessens the degree of culpability which the SEC must prove. Under § 21(d), only conduct which violates § 10(b) may be enjoined; only such conduct as exhibits *scienter* violates § 10(b). The statutory history of the pertinent provisions fully supports the same conclusion. The requirement of *scienter* for injunctive relief is not inconsistent with the statutory structure considered in *Hochfelder* and, indeed, a contrary conclusion would produce anomalous statutory consequences. Finally, the Court below was incorrect both in relying at all on policy considerations to support its adherence to pre-*Hochfelder* doctrine and in its analysis of the policy considerations once it undertook to consider them.

All of these considerations—statutory language, history, structure and policy—must be viewed in this case in the light of *Hochfelder*. The Institute submits that the Court below misapprehended the significance of *Hochfelder* on this issue and that an appropriate consideration of these elements leads irresistibly to the conclusion that *scienter* is required in SEC injunction actions.

A. The relevant statutory language mandates that *scienter* be established in all actions brought under § 10(b)

1. *The Language of § 10(b)*

This Court has become increasingly adamant in its insistence that questions of statutory interpretation must always begin—and, where appropriate, end—with an understanding of the adequately clear statutory language. As this Court said in *Hochfelder*:

> In view of the language of § 10(b), which so clearly connotes intentional misconduct, and mindful that the language of a statute controls when sufficiently clear in its context, *United States* v. *Oregon*, 336 U.S. 643, 648 (1961); *Packard Motor Car Co.* v. *NLRB*, 330 U.S. 485, 492 (1947), further inquiry may be unnecessary. 425 U.S. at 201.

In *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, —— U.S. ——, 48 U.S.L.W. 4001, 4002 (Nov. 13, 1979), the Court reiterated its view that the language of the statute itself is the touchstone of statutory construction. In *Touche Ross & Co.* v. *Redington*, 99 S. Ct. 2479, 2485 (June 18, 1979), the Court emphasized that other considerations play no part in statutory interpretation when the legislative text itself is clear. In short, this Court's requirement that

statutory analysis focus upon the plain meaning of statutory language is now well settled. *E.g., Cannon* v. *University of Chicago*, 99 S. Ct. 1946, 1953 (May 14, 1979); *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 472 (1977); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1, 24 (1977); *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 756 (1975) (Powell, J. concurring).

The Court below paid only lip service to this requirement, deciding that the language of the section alone was "not determinative" of the issue. [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,130. The Court divined from a history of differing judicial interpretations of the language of § 10(b) that the statutory language was unclear as to whether or not *scienter* was a component of a violation of its terms. Without further analysis or discussion, the Court left the question of statutory exegesis and passed on to other methods of statutory interpretation.

This casual treatment of the statutory text accords with neither the method nor the result required by *Hochfelder*. For in *Hochfelder* this Court authoritatively interpreted the language of § 10(b) and left no residual doubt as to the conduct embraced by its prohibitions. The Court there concluded that the statutory "words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct." 425 U.S. at 197. The Court found that the use of such words made "unmistakable a congressional intent to proscribe a type of conduct quite different from negligence". *Id.* at 199. The Court specifically found that the language of § 10(b) "clearly connotes intentional misconduct". *Id.* at 201.

Such unclarity as may have subsisted in the judicial interpretation of the statutory language before *Hochfelder*

did not survive the definitive interpretation of that language there announced. What emerges from the *Hochfelder* interpretation is a clear understanding that § 10(b) proscribes conduct involving *scienter* and does not proscribe conduct which does not involve *scienter*. *Scienter* is, in short, definitively established to be an indispensable ingredient of those acts or practices violative of the section.

Of course, as the Court of Appeals below recognized, the statutory language is the same whether the relief sought for its violation be an award of damages or an injunction and whether the plaintiff is a private party or the SEC. [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,130. In *Hochfelder,* the SEC itself argued, and Justices Blackmun and Brennan noted in dissent, that the question of whether negligent conduct constitutes a violation of § 10(b) should not depend upon the plaintiff's identity. 425 U.S. at 217 (Blackmun, J. dissenting); *see* Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder,* 51 N.Y.U.L. Rev. 769, 778 & n.66 (1976).

There appears, then, in the text of the operative prohibitory section nothing to suggest that an injunction can be obtained against conduct which does not involve provable *scienter*.

2. *The Language of § 21(d)*

The Court in *Hochfelder,* of course, was considering the content and meaning of § 10(b) for the purpose of determining the elements of a *prima facie* case to enforce the implied cause of action for damages previously held by the Court to be available. Here, however, the SEC does not depend upon an implied cause of action; the cause of action

for injunctive relief at the instance of the Commission is explicitly created by § 21(d) of the 1934 Act and its elements are prescribed by the language of that section.

The text of § 21(d) is unambiguous. It requires an affirmative showing that a person "is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter . . . ." The language plainly incorporates by reference the proscriptive content of other provisions of the 1934 Act—in this case of § 10(b). As this Court has conclusively determined that § 10(b) proscribes only conduct committed with the requisite *scienter,* it is only such conduct for which the SEC can seek relief under § 21(d). Nothing in the statutory language of § 21(d) authorizing injunctive relief intimates that by its own terms any of the elements of a violation of other provisions of the chapter are relaxed or that the prohibitory scope of those other provisions is in anyway expanded.

The net result of an examination of the statutory language, in the light of the *Hochfelder* interpretation of § 10(b), then, is unmistakable: Under § 21(d) only that conduct which violates § 10(b) may be enjoined when the latter section is invoked as the basis for seeking injunctive relief; and only such conduct as exhibits the requisite *scienter* is prohibited by and constitutes a violation of § 10(b). The statutory language leaves little room for considerations of history, structure or policy, given the force of its plain meaning. An examination of those further considerations, however, reinforces the view that the statutory language indeed means what it says.

B. The relevant statutory history indicates that *scienter* must be shown in SEC injunctive actions for violations of § 10(b)

1. *The Legislative History of § 10(b)*

After examining the language of § 10(b) and concluding that it unmistakably proscribed intentional and wilful misconduct, the Court next turned to the legislative history of the 1934 Act and found that "relevant portions of that history support our conclusion that § 10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone." 425 U.S. at 201. A consideration of that history in the light of the issue presented here leads to an identical conclusion.

It is unnecessary to reiterate here the analysis of the history of § 10(b) set out by the Court in *Hochfelder,* 425 U.S. at 201-06, or to examine again the materials upon which that review depended. Just as with the language of § 10(b), the legislative history of that section, and of the 1934 Act as a whole, is the same whether it is interpreted in connection with an action for damages or one by the SEC for an injunction. All the elements of legislative history marshalled by the Court to establish the necessity of showing *scienter* for damage relief equally establish the necessity for the same showing when injunctive relief is sought.

Indeed, that legislative history is even more pertinent to the issue presented in this case. In *Hochfelder,* the Court mined the legislative history to discover clues to the putative intent of the Congress about the elements of a cause of action which, in fact, was not implied by the courts until 12 years after the 1934 Act was passed. *See Kardon*

v. *National Gypsum Co.,* 65 F. Supp. 512, 513-14 (E.D. Pa. 1946). The exercise which occupied the Court in *Hochfelder* was to define from those historical materials what the intent of the Congress would have been had it focused on the elements of a private cause of action for damages during the consideration of the 1934 Act. The Court concluded from the evidence of what the Congress and the draftsmen thought about issues which were before them that they plainly intended *scienter* to be an element of the conduct proscribed by § 10(b) and would have articulated such a view about damage suits if they had focused on that question.

The whole history of the section is even more persuasive in this case precisely because injunctive relief at the instance of the SEC was one of the issues before the Congress in explicit terms when the 1934 Act was considered. *See SEC* v. *Blatt,* 583 F.2d 1325, 1333 n.21 (5th Cir. 1978). The legislative materials indicating an intent to require *scienter* as an element of the conduct forbidden by § 10(b) constitute the very history that developed in the course of considering "clear statutory provisions reinforced by penal and civil sanctions" of which civil sanctions the injunction was explicitly one. S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1934). *See Hochfelder,* 425 U.S. at 204-05. Since this history in fact reflects the deliberative process of draftsmen and legislators who were directly concerned with injunctive actions under § 10(b), the conclusion that *scienter* was regarded as an indispensable ingredient of the proscribed conduct for that purpose is even more certain than that it was intended to be an element of private damage actions. *See* Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder,* 51 N.Y.U.L. Rev. 769, 776 (1976).

2. *The Legislative History of § 21(d)*

The Court of Appeals concluded that the legislative history of § 21(d) buttressed its holding that *scienter* was not intended to be required in SEC injunction actions. The Court relied largely on what it termed the "legislative discussion" of § 21(d) occurring upon the enactment of the Securities Acts Amendments of 1975. Seizing in particular upon a statement in a Senate Report indicating that *scienter* was not an element "required to be demonstrated in a Commission injunctive action", S. Rep. No. 75, 94th Cong., 1st Sess. 76 (1975), *citing SEC* v. *Everest Management Corp.*, 475 F.2d 1236, 1240 (2d Cir. 1972), the Court concluded: "It would be difficult to find a clearer indication, at the time of the enactment of § 21(d), that Congress intended to exempt SEC injunction actions from the scienter requirement applicable to private actions." [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,131.

This "legislative discussion" provides little, if any, support for the Court's holding. Statements in the Senate Report simply do not fairly qualify as legislative history of § 21(d), inasmuch as § 21(d) was not enacted, nor was its substantive content altered in any way, by Congress as part of the amendments of 1975. The amendments of 1975 merely renumbered former § 21(e) as present § 21(d). Legislative intent must be gleaned from events contemporaneous with a statute's enactment rather than from a gloss imposed by subsequent legislative constructions. *See Transamerica Mortgage Advisors, Inc.* v. *Lewis*, —— U.S. —— , 48 U.S.L.W. 4001, 4004 n.13 (Nov. 13, 1979); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 199-200 (1963); *United States* v. *Philadelphia National Bank*, 374 U.S. 321, 348-49 (1963). This Court has not infrequently cautioned that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *United States* v. *Price*, 361 U.S. 304, 313 (1960).

Moreover, the observations contained in the Senate Report that *scienter* was not required in an SEC injunction action should be accorded little weight for another reason. Such conclusion was undoubtedly based upon an analysis of existing case law which indeed provided some support for the conclusion. *Compare SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 863 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976 (1969) *with SEC* v. *Coffey*, 493 F.2d 1304, 1314 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975). However, such case law pre-dated this Court's construction of § 10(b) in *Hochfelder* and therefore, unless consistent with *Hochfelder*, is of no further vitality.

Apart from the "legislative discussion" of § 21(d) in the Senate Report pertaining to the Securities Acts Amendments of 1975, the Court of Appeals relied upon additional legislative history contemporaneous with the enactment of the 1933 and 1934 Acts. However, the legislative history relied upon by the Court, *see* [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,130 n.14, pertains not to the availability of an injunction under § 21(d) of the 1934 Act, but rather, to the standard of culpability requisite for a violation of § 17 of the 1933 Act. The fact that Congress, in enacting the 1933 Act, ultimately rejected a standard of wilful conduct under § 17, as proposed by the Senate draft, S. 875, 73d Cong., 1st Sess. § 13, 77 Cong. Rec. 2982 (1933), and thereafter at the time of the enactment of the 1934 Act similarly rejected a proposed amendment to § 17 to require such a showing of wilfulness,

78 Cong. Rec. 8703 (1934), has no bearing on the standard of culpability necessary for issuance of an injunction under § 21(d) for violation of § 10(b) of the 1934 Act. Moreover, the statement by the Court of Appeals that the same pattern of culpability requirements established by the 1933 Act were incorporated in the 1934 Act finds no support in the provision cited by the Court. Act of June 6, 1934, Pub. L. No. 291, ch. 404, § 210, 48 stat. 881. That section merely transfers the administration of the 1933 Act from the Federal Trade Commission to the Securities and Exchange Commission.

In sum, the Institute submits that this Court's concluding language in *Hochfelder* applies with equal, if not greater, force to injunctive actions brought by the SEC under § 21(d):

> When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances—the commonly understood terminology of intentional wrongdoing—and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct. 425 U.S. at 214 (footnote omitted).

C. To Hold That *Scienter* Is Not Required In Injunctive Actions Would Produce Statutory Incongruity

The Court in *Hochfelder* found additional support for its interpretation of § 10(b) in the tightly interwoven network of statutory provisions in the 1933 and 1934 Acts. It found that permitting an implied cause of action for a violation of § 10(b) to be maintained without a showing of *scienter* would be inconsistent with the procedural safeguards which circumscribed the causes of action expressly created by the

Acts. 425 U.S. at 206-11. The Court below thought that interpreting § 10(b) as not requiring *scienter* in injunctive cases did not do any violence to the scheme which this Court analyzed in *Hochfelder*. While the Court below overlooked one major anomaly that would ensue from such an interpretation, it is at least fair to comment that taking the Court of Appeals' viewpoint at face value, its converse is also true: There is also nothing inconsistent with the statutory scheme in requiring a showing of *scienter* for injunctive relief.

The Court of Appeals, however, again failed to come to grips with the significance of a portion of the *Hochfelder* decision. A correct understanding of the implications of Part II D of *Hochfelder*, 425 U.S. at 212-14, indicates that unless *scienter* is required for SEC injunctive relief a statutory absurdity would result. The passage addresses a contention, submitted by the SEC, that subsections (b) and (c) of Rule 10b-5 were cast in language which, if standing alone, could encompass both intentional and negligent behavior. From this the Commission argued that a cause of action could be made out under these subsections of the Rule in the absence of a showing of *scienter*.

The Court rejected this contention in part on the ground that it was inconsistent with the administrative history of the adoption of the Rule itself. 425 U.S. at 212. The Court, however, went further in an analysis that is instructive on the present issue. The Court specifically held that if Rule 10b-5 attempted to prohibit conduct which was not prohibited by § 10(b), from which the Commission derived the authority to issue the Rule at all, then Rule 10b-5 was, to that extent, invalid. The Court emphasized that "[t]he rulemaking power granted to an administrative agency charged with the administration of a federal statute is not

the power to make law." *Id.* at 213. Rather, the Court went on to hold:

> [I]t is "'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.'" *Dixon* v. *United States,* 381 U.S. 68, 74 (1965), quoting *Manhattan General Equipment Co.* v. *Commissioner,* 297 U.S. 129, 134 (1936). Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b). For the reasons stated above, we think the Commission's original interpretation of Rule 10b-5 [requiring *scienter*] was compelled by the language and history of § 10(b) and related sections of the Acts. See, *e.g., Gerstle* v. *Gamble-Skogmo, Inc.,* 478 F. 2d 1281, 1299 (CA2 1973); *Lanza* v. *Drexel & Co.,* 479 F. 2d 1277, 1304-1305 (CA2 1973); *SEC* v. *Texas Gulf Sulphur Co.,* 401 F. 2d, at 868 (Friendly, J., concurring); 3 Loss, supra, n. 17, at 1766; 6 *id.,* at 3883-3885. *Id.* at 214.

Thus, the Court held that in enforcement of § 10(b) the Commission does not have the power to promulgate a rule which forbids conduct not involving *scienter.* If, however, § 10(b) should be construed as not requiring *scienter* in injunctive actions, the incongruous result would ensue that the Commission could prohibit by injunctive action that which it has no authority to prohibit under its own rulemaking power. Given the evident respect which the Congress and the courts have accorded to the SEC's authority to make appropriate rules for the administration and enforcement of the securities laws, it would be anomalous to suggest that § 10(b) means less when read as the grant of the Commission's rulemaking power than it means when read as the source of a claim for injunctive relief.

Moreover, the Court in holding that the Commission lacked power to proscribe unintentional or negligent behavior under § 10(b) plainly went beyond construing the elements of a private cause of action for damages. This portion of the *Hochfelder* opinion examines § 10(b) as a rudimentary source of SEC authority. The constraints which the Court found to limit the SEC's rulemaking authority limit *pari passu* its authority to seek injunctive relief derived from the same statutory source.

Thus, whether examined from the standpoint of a literal reading of the plain language of the pertinent statutory texts, or from the legislative history or a consideration of the anomalous consequences of a contrary ruling, the result appears plain. Section 10(b) does not prohibit unintentional conduct and the SEC, drawing on the powers it derives from that section, may not seek to enjoin such conduct.[3]

3. This conclusion is not disturbed by the reading which some lower federal courts have given to *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U.S. 180 (1963), as standing for the proposition that the SEC need not prove *scienter* in order to obtain injunctive relief prohibiting future violations of § 10(b). *See, e.g., SEC* v. *World Radio Mission, Inc.,* 544 F.2d 535, 540 (1st Cir. 1976); *SEC* v. *Manor Nursing Centers, Inc.,* 458 F.2d 1082, 1096 (2d Cir. 1972); *SEC* v. *Pearson,* 426 F.2d 1339, 1343 (10th Cir. 1970). Neither the District Court nor the Court of Appeals below cited *Capital Gains* for this proposition. Accurately read, *Capital Gains* does not support that proposition at all.

In *Capital Gains,* the defendants were engaging in the repeated practice of purchasing shares of a security for their own accounts shortly before recommending the security to their clients and immediately selling their own shares after the ensuing rise in the market price. 375 U.S. at 183. Defendants never disclosed any aspect of these transactions to their clients. *Id.* This Court held that the SEC need not prove fraud and deceit "in their technical sense," including "intent to injure and actual injury to clients" (375 U.S. at 185-86) in order to obtain limited injunctive relief under the Investment Advisers Act of 1940, 15 U.S.C. § § 80b-1 - 80b-21 (1976) (the "1940 Act"). The Court did not hold that negligence—a word it never used—is a sufficient degree of culpability upon which to grant

(footnote continued on following page)

D. To The Extent That Policy Is Pertinent At All, Sound Policy Considerations Favor A *Scienter* Requirement In § 10(b) Injunction Actions

Despite the plain language and legislative history of § 10(b), the Court of Appeals below decided that *scienter* was not a necessary element of § 10(b) and Rule 10b-5 injunction actions, largely relying upon "policy considerations underlying the securities acts", namely, "that the increased effectiveness of government enforcement actions predicated on a showing of negligence alone outweighed the danger of potential harm to those enjoined from violating the securi-

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(footnote continued from previous page)

the SEC injunctive relief under the 1940 Act. It merely held that the SEC need not prove that the investment adviser specifically intended by its actions to injure or do harm to its clients, in order to obtain an injunction, limited in scope, against further violations of § 206 of the 1940 Act ("§ 206"). 375 U.S. at 195.

Capital Gains does not support the proposition that injunctive relief may be granted for violations *of § 10(b)* in the absence of a showing of *scienter* for two additional reasons. First, in *Capital Gains,* the Court construed a statute which was crucially different in its language. Like Rule 10b-5, but unlike § 10(b), § 206 proscribed "any . . . practice . . . which operates as a fraud or deceit". The Supreme Court has since recognized that such language does not necessarily imply a requirement of intent to deceive. *Ernst & Ernst* v. *Hochfelder,* 425 U.S. 185, 212 (1976). In contrast to that language, however, this Court in *Hochfelder* specifically decided that the phrase "manipulative or deceptive device" set forth in § 10(b) clearly does impose such a *scienter* requirement. *Id.* at 199-201; *see also, Steadman* v. *SEC,* 603 F.2d 1126, 1131-32 (5th Cir. 1979) (distinguishing the language of § 17(a), which is nearly identical to the operative terms of § 206, from the language of § 10(b)).

Second, the Court in *Capital Gains* relied heavily upon the legislative history of the 1940 Act. *See* 375 U.S. at 186-95. On the basis of that legislative history, the Court concluded that the statute was enacted, in part, to prevent violations of fiduciary duty by investment advisers. *Id.* at 189-92. As we have already developed, *Hochfelder* specifically found that there was no indication in the legislative history of the 1934 Act that § 10(b) was intended to proscribe conduct not involving *scienter.* 425 U.S. at 202, 206.

ties laws."[4] [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,800 at 95,129. The Court's reliance on policy in the face of the clear language and legislative history of § 10(b) was utterly inappropriate as *Hochfelder* itself teaches and as subsequent cases confirm. *Touche Ross & Co.* v. *Redington,* 99 S. Ct. 2479 (June 18, 1979); *Transamerica Mortgage Advisors, Inc.* v. *Lewis,* —— U.S. ——, 48 U.S.L.W. 4001 (Nov. 13, 1979).

In *Hochfelder,* this Court concluded that since the language and history of § 10(b) were "dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of policy, set forth by the parties, that may have influenced the law-makers in their formulation of the statute." 425 U.S. at 214 n.33.

The generalized concerns about the underlying policies of the securities laws which the Court below invoked as a principal ground of interpretation simply will no longer do as a substitute for rigorous statutory analysis. As this Court held earlier this year in *Touche Ross & Co.* v. *Redington,* 99 S. Ct. 2479 (June 18, 1979):

> The invocation of the "remedial purposes" of the 1934 Act is similarly unavailing. Only last Term, we emphasized that generalized references to the "remedial purposes" of the 1934 Act will not justify reading a provision "more broadly than its language and the statutory scheme reasonably permit." *Securities and Exchange Commission* v. *Sloan,* 436 U.S. 103, 116, 98 S. Ct. 1702, 1711, 56 L. Ed. 2d 148 (1978); see *Ernst & Ernst* v. *Hochfelder,* 425 U.S., at 200 . . . . The ultimate question is one of congres-

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4. It should be noted that those same policy considerations of effective enforcement could well lead to the conclusion that a violation can occur without any degree of culpability on defendant's part.

> sional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law. *Id.* at 2490.

The Court below, therefore, should not have used policy considerations as governing criteria for its statutory analysis. Having begun the process of policy consideration, moreover, the Court of Appeals satisfied itself with rote incantations about the necessity for flexible and effective SEC enforcement authority. This approach not only begs the central question, but it also ignores, as explained below, the increasing modern understanding that wide-ranging injunctive power can do unwarranted harm. *See, e.g., SEC* v. *Blatt,* 583 F.2d 1325, 1334 (5th Cir. 1978); *SEC* v. *Commonwealth Chemical Securities, Inc.,* 574 F.2d 90, 99 (2d Cir. 1978).

The Institute urges that sound policy considerations require that *scienter* be shown in injunction actions brought for violations of § 10(b) and Rule 10b-5. Contrary to the view expressed by the Court of Appeals below, effective enforcement of § 10(b) and Rule 10b-5 is neither precluded nor substantially hampered by imposing a requirement that the SEC prove *scienter*. The SEC has not contended and we do not construe the decision of the Court of Appeals as holding that an injunction may issue simply upon the finding of acts of past negligence. Whatever level of culpability the SEC must show to establish a violation of § 10(b) in order to obtain injunctive relief, it must also establish a likelihood that the conduct of the defendant will recur. *E.g., SEC.* v. *Blatt,* 583 F.2d 1325, 1334 (5th Cir. 1978); *SEC* v. *Keller Corp.,* 323 F.2d 397, 402 (7th Cir. 1963); *Cf. United States* v. *W.T. Grant Co.,* 345 U.S. 629, 633 (1953) (likelihood of recurrence a necessary element for injunctive relief under § 11 of the Clayton Act, 15 U.S.C. § 21 (1976)).

Where *scienter* has been established, a likelihood of recurrence may, under certain circumstances, be inferrable without proof that the conduct is actually continuing since the wilfulness may itself imply a propensity toward repetition. *See, e.g., SEC* v. *Management Dynamics, Inc.,* 515 F.2d 801, 807 (2d Cir. 1975). Such an inference has not been thought generally proper from proof of past acts of simple negligence.[5] A likelihood of recurrence might, of course, be established by showing that defendant was persisting in a course of negligent conduct. But in many such cases an inference of *scienter* could be drawn from defendant's persistence in that course of conduct. In such cases, the SEC would not need to premise its case on negligence at all in order to prevent such on-going misbehavior. In sum, effective enforcement of § 10(b) would not be materially impaired by holding that a claim for injunctive relief could be established only by a showing of *scienter.*

In stating that effective enforcement of the securities acts outweighed the danger of potential harm to those enjoined, the Court below relied upon two of its own decisions which minimized the hardship which may result from the issuance of an injunction. *SEC* v. *Spectrum, Ltd.,* 489 F.2d 535, 541 (2d Cir. 1973); *SEC* v. *Texas Gulf Sulphur*

5. It has long been settled that evidence of a prior negligent act is inadmissible to prove that an individual again acted negligently. *Barnes* v. *Norfolk Southern Railway Co.,* 333 F.2d 192, 197 (4th Cir. 1964); *Brownhill* v. *Kivlin,* 317 Mass. 168, 171, 57 N.E.2d 539, 540 (1944); *Levant* v. *Leonard Wasserman Co.,* 445 Pa. 380, 382-83, 284 A.2d 794, 796 (1971). A serious question exists as to whether injunctive relief should ever be issued on the basis of negligent conduct or to restrain negligent conduct. Since negligence is inadvertent and unintended, no legitimate purpose appears to be served by enjoining it. There is also a serious question as to whether a violation of an injunction may be found on the basis of subsequent negligent acts. These questions are alluded to in *SEC* v. *Universal Major Industries Corp.,* 546 F.2d 1044, 1047 n.1 (2d Cir. 1976), *cert. denied sub nom. Homans* v. *SEC,* 434 U.S. 834 (1977).

Co., 401 F.2d 833, 854-55, 868 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates* v. *SEC*, 394 U.S. 976 (1969). Contrary to the views expressed in those cases, there has been a recent judicial recognition—according more realistically with actual experience—that the consequences flowing from the issuance of an injunction for violations of § 10(b) can be quite severe. *SEC* v. *Blatt*, 583 F.2d 1325, 1334 (5th Cir. 1978); *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90, 99 (2d Cir. 1978).[6]

The effects are particularly detrimental when the injunction is directed against professionals such as accountants. The mere determination that an accountant violated the antifraud sections of the federal securities laws—which under the decision of the Court of Appeals below could well occur upon a finding of a single act of negligence—even in the absence of the issuance of an injunction, could have extremely significant adverse consequences. The publicity which will almost certainly attend the issuance of an injunction or a finding of a federal securities act violation will plainly and often irrevocably affect the reputation of

6. In the area of SEC administrative proceedings, the courts have emphasized the substantial, detrimental effects that ensue to a defendant when an adverse decision is rendered. *E.g., Steadman* v. *SEC*, 603 F.2d 1126, 1138-43 (5th Cir. 1979); *Whitney* v. *SEC*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) § 96,913 at 95,779 (D.C. Cir. 1979) ("[A] suspension for nine months imposes a serious loss, both as a short-run matter of foregone business, and, perhaps more greviously, as a permanent injury to reputation."); *Collins Securities Corp.* v. *SEC*, 562 F.2d 820, 823-26 (D.C. Cir. 1977). In recognition of these serious repercussions, the courts have required that the SEC support its factual findings of a violation with clear and convincing evidence, rather than a preponderance of the evidence. Application of the higher burden of proof balances the interests of the public and the individual. "Its use in SEC disciplinary proceedings does not forego the 'remedial' aspect of protecting the public." *Id.* at 825-26.

an accountant.[7] This in turn will have a direct and often substantial effect on an accountant's ability to practice his profession. As Judge Friendly recently stated in *SEC* v. *Commonwealth Chemical Securities, Inc.*, 574 F.2d 90 (2d Cir. 1978):

> It is fair to say that the current judicial attitude toward the issuance of injunctions on the basis of past violations at the SEC's request has become more circumspect than in earlier days. Experience has shown that an injunction, while not always a "drastic remedy" as appellants contend, often is much more than the "mild prophylactic" described by the dissenters in this court in *SEC* v. *Capital Gains Research Bureau, Inc.*, 306 F.2d 606, 624 (2 Cir. 1962), a phrase quoted by the Supreme Court at 375 U.S. 180, 193, 84 S.Ct. 275, 11 L.Ed. 2d 237 (1963). In some cases the collateral consequences of an injunction can be very grave . . . . *Id.* at 99 (footnote omitted).

It should be noted that not requiring the SEC to show *scienter* may involve serious risks for, and may be particularly unfair to, professionals such as accountants. Accountants are regularly called upon to make difficult judgments which require a weighing of complex facts and as to which there is no plain or simple answer. SEC injunction actions often retrospectively challenge such judgments. If *scienter* need not be shown, accountants would

7. Aside from the reputational effects, a wide range of serious collateral consequences flow from an injunctive decree. *See Program of the Committee on Federal Regulation of Securities*, 30 Bus. Law. 1303, 1307-11 (1975) [hereinafter cited as *Federal Regulation of Securities*] (comments of Arthur Mathews). With respect to accountants and other professionls who are named defendants, Rule 2(e) of the SEC's Rules of Practice, 17 C.F.R. § 201.2(e), has a particularly onerous effect. Pursuant to that Rule, the mere entry of an injunctive order—even one entered on consent when the professional does not admit wrongdoing—can provide the basis for precluding a professional from practicing before the Commission. *Federal Regulation of Securities, supra*, at 1310.

face the risk of being found to have violated § 10(b) and being subject to injunctive relief on the basis of hindsight assessments of earlier good faith accounting or auditing judgments, as to which reasonable men may disagree. This is simply too loose a standard upon which to expose accountants to the severe consequences of injunctive relief. In light of the difficulty of predicting the outcome of SEC injunction actions premised on negligence, it can be expected that accountants will often feel compelled, unfairly, to enter into consent judgments.

It is an unfortunate fact that all too frequently persons peripherally involved in a transaction which is the subject of an SEC injunction action, such as accountants or lawyers, who are claimed to have been no more than negligent, will suffer more from the issuance of injunctive relief than the alleged principal wrongdoers, who are alleged to have been guilty of a high degree of *scienter*. Such principal wrongdoers frequently have little to lose from the issuance of an injunction since their vocations do not depend heavily —and certainly not to the same extent as accountants and other professionals—upon the strength of their reputations. On the other hand, professionals who may only be tangentially involved in a challenged transaction and who may be guilty of no more than a failure to exercise proper judgment, may have their entire professional careers jeopardized by the issuance of an injunction.[8] It can also be expected that if a professional is found to have violated the federal antifraud statutes on the basis of negligence, the world will not make the NICE discriminations necessary to differentiate his role and culpability from that of the primary wrongdoers who may have been found guilty of

8. In fact, with respect to injunctions issued against large accounting and law firms, the impact of the injunction may be felt by all of their partners and professional staff, the vast majority of whom had no involvement at all in the matter. *Federal Regulation of Securities, supra* note 7, at 1321 (comments of Victor M. Earle).

egregious fraud. The effect on the accountant in such cases of a determination that he violated § 10(b) will bear no fair relationship to his wrongdoing.

The Court below therefore erred in regarding policy outcomes as determinative of the statutory question, and erred again in its simplistic assessment of the policy considerations it examined. Nothing in a "circumspect" weighing of policy considerations in any way undermines the conclusion dictated by the statutory language, history and structure. *Scienter* is an element of a violation of § 10(b) and there is no sound reason to dispense with it in SEC injunction actions.

CONCLUSION

The opinion of the Court of Appeals for the Second Circuit should be reversed and the cause remanded for further proceedings in light of this Court's expressions on the necessity of pleading and proving *scienter*.

Respectfully submitted,

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IN THE

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No. 79-66

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Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

MOTION OF SECURITIES INDUSTRY ASSOCIATION FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE*

and

BRIEF *AMICUS CURIAE* OF SECURITIES INDUSTRY ASSOCIATION

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MOTION OF SECURITIES INDUSTRY ASSOCIATION FOR LEAVE TO FILE A BRIEF *AMICUS CURIAE*

The Securities Industries Association (the "SIA") hereby respectfully moves, pursuant to Rule 42 of the Rules of this Court, for leave to file the attached brief *amicus curiae* in order to present its views as to the standards properly governing the issuance of an injunction against violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b)(1976) ("Section 10(b)"), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979) ("Rule 10b-5"). The SIA submits that the Court of Appeals for the

Second Circuit erred in its formulation and application of these standards and contends the judgment of that Court should be reversed and the cause remanded for further proceedings.

The SIA is a national trade association representing approximately 500 brokers and dealers responsible for over 90 percent of the securities brokerage and investment banking business of the nation. Its membership is a cross-section of the diverse facets of the securities business and encompasses members of national securities exchanges as well as firms which are not members of such exchanges. The firms which comprise the SIA's membership are located across the nation and provide services to investors of every description. Almost all of SIA's members are registered as broker-dealers with the Securities and Exchange Commission ("SEC"). SIA is generally regarded as a principal spokesman for the securities industry before legislative, regulatory and judicial bodies.

Broker-dealers are at the very heart of the business regulated by the SEC pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934. The antifraud provisions of Section 17(a) and Rule 10b-5 are frequently the basis for SEC injunction actions against broker-dealers. This case presents an issue which is of prime importance to broker-dealers—i.e., whether an injunction based upon the antifraud provisions can be obtained by the SEC on a showing of negligence alone—without any proof of scienter.

If the antifraud provisions were held to include, for purposes of SEC injunction actions negligent as well as intentional and reckless conduct, there surely would be a substantial increase in the number of SEC injunction actions under the antifraud provisions instituted against

broker-dealers and a corresponding increase of the number of broker-dealers who would become subject to such injunctions, either by way of a settlement of such cases or after a litigation on the merits. The mere institution of fraud charges against the broker-dealer inevitably result in very serious consequences for its business, which are magnified by the actual issuance of an antifraud injunction. Moreover, the entry of an injunction against a broker-dealer subjects the broker-dealer to the imposition of serious administrative disciplinary sanctions under 15(b) of the 1934 Act. The unique interest of the SIA therefore in the outcome of this litigation is obvious.

The SIA determined to submit to this Court a brief *amicus curiae* only after having a chance to review the Petitioners Brief and the Brief *amicus curiae* filed by the American Institute of Certified Public Accountants ("AICPA"). A review of these briefs indicated to the SIA that considerations believed to be important to this Court's decision of this case were not discussed in either brief. Accordingly, the attached Brief *Amicus Curiae* focuses on the issues and authorities not covered in the other briefs.

More specifically, the issues covered in the SIA Brief, and not covered elsewhere, include (1) important-considerations relating to the applicability of the scienter requirement to Section 17(a), including an analysis of the legislative history and the overall structure of the 1933 and 1934 Acts; (2) the legislative history of Section 21(d) of the 1934 Act, 15 U.S.C. § 78u(d), which was relied upon by the Second Circuit below; (3) the interrelationships between injunctions and administrative disciplinary sanctions on broker-dealers under Section 15(b) of the 1934 Act, 15 U.S.C. §78o(b), (4) the established equitable principles governing the availability of injunctive relief; (5) the prerequisites for injunctive relief under Section 20(b) of the 1933 Act, 15 U.S.C. § 77t(b) (1976), and

Section 21(d) of the 1934 Act; and (6) the requirement that injunctions be specific in their commands as required by Rule 65(d) of the Federal Rules of Civil Procedure.

Where our views are substantially similar to those of the AICPA, reference is made to the AICPA Brief to avoid duplication.

Respectfully submitted,

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BRIEF *AMICUS CURIAE* OF SECURITIES INDUSTRY ASSOCIATION

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BRIEF OF SECURITIES INDUSTRY ASSOCIATION AS *AMICUS CURIAE*

PRELIMINARY STATEMENT

The Securities Industry Association (the "SIA") submits this brief *amicus curiae* in order to present its views as to the standards properly governing the issuance of an injunction against violations of Section 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b) (1976) ("Section 10(b)"), Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240.10b-5 (1979)

("Rule 10b-5") and Section 17(a) of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77q(a) (1976) ("Section 17(a)"). Section 10(b), Rule 10b-5 and Section 17(a) are generally, and herein sometimes referred to as the "antifraud provisions" of the 1933 and 1934 Acts. The SIA submits that the Court of Appeals for the Second Circuit erred in its formulation and application of these standards and contends that the judgment of that Court should be reversed and remanded for further proceedings.

OPINIONS BELOW

The opinion of the Court of Appeals (Timbers, C.J.), affirming the decision of the District Court, is reported at 605 F.2d 612 (1979) and is printed in the Appendix to the Petition for Certiorari. The Opinion of the District Court which granted the Securities and Exchange Commission ("SEC" or "Commission") a permanent injunction against petitioner Peter E. Aaron is reported at Fed. Sec. L. Rep. (CCH) ¶ 96,043 (S.D.N.Y. 1977).

QUESTIONS PRESENTED

Whether the Securities and Exchange Commission is required to establish scienter as an element of a government enforcement action to enjoin violations of Section 10(b) of the 1934 Act and SEC Rule 10b-5, or of Section 17(a) of the 1933 Act.

ADDITIONAL STATUTE INVOLVED

In addition to the statutes printed in the Petition for Certiorari and the Brief *Amicus Curiae* of the AICPA, the

following provisions of Section 15(b)(4) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(b)(4)(1976), are involved:

> The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person associated with such broker or dealer, whether prior or subsequent to becoming so associated—
>
> * * *
>
> (C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, or municipal securities dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.
>
> (D) has willfully violated any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.
>
> (E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933,

the Investment Advisers Act of 1940, the Investment Company Act of 1940, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view of preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

> (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and
>
> (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

INTEREST OF THE SIA AS *AMICUS CURIAE*

The SIA is a national trade association representing approximately 500 brokers and dealers responsible for over 90 percent of the securities brokerage and investment banking business of the nation. Its membership is a cross-section of the diverse facets of the securities business and encompasses members of national securities exchanges as well as firms which are not members of such exchanges. The business of SIA's members includes retail and institutional brokerage, over-the-counter market-making, underwriting and other investment banking activities, various exchange floor functions, and management and distribution of mutual funds. Many of its members perform these services with regard to municipal

and government, as well as corporate, securities. The firms which comprise the SIA's membership are located across the nation and provide services to investors of every description. Almost all of SIA's members are registered as broker-dealers with the SEC. SIA is generally regarded as a principal spokesman for the securities industry before legislative, regulatory and judicial bodies.

Broker-dealers are, of course, at the very heart of the business regulated by the SEC pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934. In its administration of these statutes, the SEC has developed numerous regulations specifically delineating the boundaries of permissible conduct by broker-dealers. However, inasmuch as these specific rules speak to only a portion of the myriad activities of broker-dealers, the SEC's enforcement program respecting broker-dealers has frequently involved resort to injunction actions alleging violations of the two broad generic antifraud provisions at issue in the instant case.

Another friend of the Court, the American Institute of Certified Public Accountants ("AICPA"), has called the Court's attention to the grave, and frequently unwarranted, injury to business and reputation which flows from injunctions issued against persons, such as accountants and lawyers, having ancillary relationships to the securities business. Perhaps even more vulnerable to injury from an improper application of the antifraud provisions are those, such as SIA's members, who directly participate in the securities business.

If the antifraud provisions of the 1933 and 1934 Acts were expanded to include, for purposes of SEC injunction actions, negligent as well as intentional or reckless conduct, this lowered threshold of culpability would surely subject many more honest businessmen to "fraud"

charges. The mere filing of such charges can have seriously adverse consequences on the business of a broker-dealer which necessarily depends on its reputation for integrity and honesty.

Moreover, the 1934 Act is so structured that an injunction against a broker-dealer can be transformed by administrative SEC action from a judicial command that it commit no further violations to a temporary or permanent administrative exclusion from the securities business. Section 15(b) of the 1934 Act provides that, upon a finding that it is in the public interest to do so, the SEC can suspend or revoke the registration of a broker-dealer solely for the reason that it has been temporarily or permanently enjoined by a court of competent jurisdiction. It is clear, therefore, that the broker-dealer community is uniquely affected by the outcome of this case.

That unique interest has motivated SIA to evaluate carefully the points and arguments thus far submitted to the Court by the petitioner and the Court's other amici. SIA believes that there remain important considerations, relating to the circumstances under which a violation of Section 17(a) or Section 10(b) can be enjoined, which need to be brought to the Court's attention.

STATEMENT

Petitioner was an employee of E. L. Aaron & Company, Inc. of New York City. He is also the son of E. L. Aaron who was the owner of the brokerage firm and its chief executive.

In 1975, two salesmen in a branch office on Long Island, Messrs. Schreiber and Jacobson, made representations in the sale of the stock of a company called Lawn-a-Mat which the SEC alleged to be fraudulent.

The courts found that Peter Aaron was responsible for supervising these salesmen and that he had means to know from reports in the files that the statements they made were false.

In October 1975, Peter Aaron severed his relationship with E. L. Aaron & Co. and went into the commodities business. The SEC filed the instant lawsuit on February 26, 1976. The Lawn-a-Mat Corporation is in bankruptcy. Aaron & Co. is no longer in business.

The District Court's opinion stated:

> "Peter Aaron, although never an officer, director or shareholder of Aaron & Co., by virtue of his active participation in the management of the firm and his knowledge both of the firm's solicitation of LAM stock and the false and misleading statements being made by Schreiber and Jacobson in connection with that solicitation, must be held responsible along with Schreiber and Jacobson for the fraudulent representations that were made. [Citations omitted.] While Peter Aaron himself did not make any misrepresentations, by failing to stop Schreiber and Jacobson, he wilfully aided and abetted their violations of the anti-fraud provisions [Section 17(a) and Rule 10b-5] of the securities laws." *SEC* v. *E. L. Aaron & Co., Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 96,043 at 91,684 (S.D.N.Y. 1977).

The court further held—"the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws." *Id.* at 91,685.

The Court of Appeals affirmed the decision of the District Court but did "not reach the question whether Aaron's conduct would support a finding of scienter." *SEC*

v. *Aaron*, 605 F.2d 612, 619 (2d. Cir. 1979). Instead it held that "proof of negligence alone will suffice" in an SEC enforcement action under Section 10(b), Rule 10b-5 and Section 17. This raised the issue now before this Court.

The injunction, issued by the District Court, and affirmed by the Second Circuit, ordered Peter Aaron to be permanently enjoined in broad statutory and regulatory language of Section 17 and Rule 10b-5 against employing devices, schemes or artifices to defraud, etc., in connection with the offer for sale, sale or purchase of "the common stock of Lawn-a-Mat Chemical and Equipment Corporation or any other securities." See Order Granting Injunction in *SEC* v. *E. L. Aaron & Co., Inc.*

SUMMARY OF ARGUMENT

I.

A. The rationale of this Court's decision in *Hochfelder* (for the reasons set forth in the AICPA *amicus curiae* brief) leads inexorably to the conclusion that in SEC injunction actions—as in private actions—proof of simple negligence alone is insufficient to establish a violation of Section 10(b) or Rule 10b-5.

B. *Hochfelder's* logic further dictates that Section 17(a) of the 1933 Act, whose prohibitory language is substantially identical to Rule 10b-5, be construed to require proof of scienter in SEC actions.

1. The title and language of Section 17(a), read in its context and its totality, clearly reflects a congressional intent to deal with fraud and not with negligence.

2. The legislative history of Section 17(a) speaks only in terms of fraudulent conduct. The Second

Circuit's contrary holding in *SEC* v. Coven, 584 F.2nd 1020 (2d Cir. 1978), relied upon below, is largely constructed on the sands of a clear misreading of the legislative history.

3. Given the "particularized" statutory scheme that Congress has adopted for the regulation of the securities industry—attaching varying consequences to different kinds of conduct (innocent, negligent and willful) and providing clearly defined remedies for certain specified negligent conduct—no inference that negligence alone is sufficient to establish a violation under Section 17(a) should be made. Furthermore, differentiating, in terms of scienter, between the substantially identical language of Rule 10b-5 and Section 17(a) would lead to the absurd result that the standards for injunctive relief would depend on the happenstance whether the defendant's conduct was in connection with a sale rather than a purchase of a security.

C. Sections 21(d) of the 1934 Act and Section 20(b) of the 1933 Act which authorize the SEC to seek injunctive relief against ongoing and threatened violations do not, and are clearly not intended, to modify the elements of the substantive violations of the antifraud provisions in cases where injunctive relief is sought.

D. The SEC, under Section 15(b)(4) of the 1934 Act can impose administrative disciplinary sanctions on broker-dealers for breaches of the antifraud provisions only upon a finding of a "willful" violation or, alternatively, on the basis of a prior injunction or criminal conviction. Eliminating the scienter requirement in SEC injunction actions would permit the SEC to short-circuit the clear congressional intent to impose such sanctions only upon proof of willful conduct.

II.

A. Federal regulatory statutes providing for injunctive relief invoke the equity jurisdiction of the federal courts and must be construed in accordance with age-old equitable principles. Such principles dictate that the courts will resort to an injunction only if necessary to deter future violations and require the "nice adjustment and reconciliation between public interest and private needs" required by *Hecht* v. *Bowles*, 321 U.S. 321, 329 (1944).

B. The Second Circuit failed to consider adequately the private injuries caused by injunctions. Under the lower threshold of the negligence standard, SEC injunction actions under the antifraud provisions undoubtedly will proliferate. The fraud charges made in such cases (even if negligence is all that can be proved) do serious damage to the reputation and business of broker-dealers against whom they are levelled, regardless of the ultimate outcome. This lower threshold also would give the SEC substantial additional leverage to exact from broker-dealers settlements, providing not only for injunctive relief, but for the imposition of severe administrative disciplinary sanctions. The issuance of antifraud injunctions based on negligent conduct permanently mars the reputation of the broker-dealer and subjects not only to criminal contempt penalties but also to other serious collateral consequences.

C. In contrast, no countervailing "public interest", in terms of SEC enforcement policy, can be shown for lowering the threshold for injunctive relief under the antifraud provisions to negligence alone. Criminal contempt is not an effective tool against negligence since willfullness itself is an essential prerequisite for a finding of criminal contempt.

III.

A. This Court, on remand, should provide the lower courts with guidance on the proper application of Section

20(b) of the 1933 Act and Section 21(d) of the 1934 Act which expressly limit injunctive relief to cases where there is adequate proof of an ongoing or threatened future violation.

B. This Court, consistent with its prior decisions, should further instruct the lower courts that an injunction whose prohibitions are phrased only in broad and general language of Section 17(a) and Rule 10b-5—as does the decree before the Court here—fails to comply with the specificity requirements of Rule 65(d) of the Federal Rules of Civil Procedure and the notions of basic fairness which require that the potent weapon of criminal contempt charges be limited to cases where there is a specific and reasonably detailed judicial command.

ARGUMENT

I. THE SEC IS NOT ENTITLED TO AN INJUNCTION RESTRAINING VIOLATIONS OF THE ANTIFRAUD PROVISIONS OF THE 1933 AND 1934 ACTS UPON PROOF OF NEGLIGENCE ALONE

A. Section 10(b) and Rule 10b-5 Require Proof of Scienter.

In *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976) (hereinafter *Hochfelder*), this Court held that a private cause of action for damages will not lie "under § 10b and Rule 10b-5 in the absence of any allegation of 'scienter'—intent to deceive, manipulate, or defraud." *Id.* at 193.

The *Amicus* Brief filed by the AICPA demonstrates that this Court's considerations in *Hochfelder* regarding "statutory language, history, structure and policy" lead irresistibly to the conclusion that "scienter is also required in SEC injunction actions" under Section 10(b) and Rule 10b-5. AICPA Brief at 8. The SIA fully agrees with and

strongly supports the arguments made by the AICPA. It does not reiterate these arguments here only to avoid burdening this Court with unnecessary duplication.

Given the persuasive counterindications in *Hochfelder* (as discussed in AICPA brief) of any congressional intent to make the scienter requirement inapplicable to SEC injunctions as distinct from private actions, the only possible basis remaining for such a distinction would necessarily have to be premised on what the Second Circuit below referred to as the "increased effectiveness of government enforcement actions predicated on a showing of negligence alone", 605 F.2d at 621. This Court, however, has "emphasized that generalized references to the 'remedial purposes' of the 1934 Act will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permits'." *Touche Ross & Co.* v. *Redington*, 99 S.Ct. 2479, 2490 (1979). In that case, the Court added that "the ultimate question is one of congressional intent, not one of whether this Court thinks that it can improve upon the statutory scheme that Congress enacted into law." *Id.*

In any event, requiring scienter for the issuance of injunctions in SEC actions brought under Rule 10b-5 (or Section 17(a) of the 1933 Act) does not leave the SEC without an impressive arsenal to protect investors. Broker-dealers are subject to administrative sanctions imposed under Section 15(b) of the 1934 Act and, as discussed below, Section 15(b)(4)(E) specifically covers failure to exercise reasonable supervision by a broker-dealer—the very conduct found to have occurred in this case. A holding that negligence alone is not a proper basis for the issuance of an injunction under the antifraud provisions would leave fully intact the SEC's power to obtain injunctive relief not only in cases of intentional conduct, but in cases of reckless conduct as well. *See Hochfelder*, 425 U.S. at 194 n.12. It would exclude in-

junctive relief only in cases of simple negligence, a type of conduct for which Congress simply did not deem it necessary to provide the potent weapon of an injunction. Furthermore, as specifically provided for in various sections of the Acts, negligent conduct subjects sellers of securities and other persons to claims for monetary damages. *See e.g.*, Sections 11 and 12(2) of the 1933 Act, 15 U.S.C. §§77k, 77l(2) (1976). Criminal penalties, of course, are available for any willful violations of both the 1933 and 1934 Acts.

B. Section 17(a) Also Requires Proof of Scienter.

The logic of *Hochfelder* applies with similar force to Section 17(a) of the 1933 Act.

The language of Section 17(a) is identical to Rule 10b-5 except that Rule 10-5 applies to any transaction "in connection with the purchase or sale of a security" while the prohibitions of Section 17(a) are limited to the "offer or sale" of a security. The prohibitions of Section 17(a) were extended to purchase transactions by the adoption of Rule 10b-5 in 1942 to close a "loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Release No. 3230 (May 21, 1942); *see Hochfelder*, 425 U.S. at 212-13 n.32.

The only other pertinent distinction between Section 17(a) and Rule 10b-5 is that Rule 10b-5 was adopted under Section 10(b) of the 1934 Act which makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of the Commission's rules. In *Hochfelder* this Court held that the scope of Rule 10b-5 was limited by the statutory provision under which it was adopted. In contrast, Section 17(a) must be construed on the basis of its own statutory language and intent.

An analysis, however, of the language, legislative history, and structure of the 1933 and 1934 Acts clearly

demonstrates that "scienter—intent to deceive, manipulate or defraud" is an essential element of an action based on Section 17(a).

The AICPA did not brief this issue. It represents, however, an issue of great importance to the SIA. Unless the identical prohibitions of Section 17(a) and Rule 10b-5 are similarly construed to require proof of scienter, future SEC injunction actions, wherever possible, would simply rely on Section 17(a) to obtain injunctive relief on the basis of negligence alone. As one District Judge noted, "[s]uch a ruling would signal the easy circumvention and swift desuetude of *Ernst.*" *Malik* v. *Universal Resources Corp.*, 425 F. Supp. 350, 363 (S.D. Cal. 1976).

I. The Language of Section 17(a)

"The starting point in every case involving construction of the statute is the language itself." *Hochfelder*, 425 U.S. at 197.

The title of Section 17(a), "Fraudulent Interstate Transactions," plainly connotes the overriding purpose and intent of the provision.

Moreover, the initial provision of Section 17(a)(1) makes it unlawful "in the offer of sale of any securities" "to employ any *device, scheme or artifice to defraud.*" (Emphasis added.) No language could more clearly be written in terms of "scienter" as defined in *Hochfelder.* Similarly, subsection 3 of Section 17(a) prohibits any "transaction, practice or course of business which operates or would operate *as a fraud or deceit* upon the purchaser."

Several circuits in post-*Hochfelder* decisions have read the language of 17(a)(1) as requiring scienter. The Fifth Circuit noted in *Steadman* v. *SEC*, 603 F.2d 1126, 1133 (5th

Cir. 1979), that the "phrases—devices to defraud, schemes to defraud, artifice to defraud—carry strong implications of intentional conduct. We do not think Congress would have used such language if it meant to reach merely negligent actions." In *Sanders* v. *John Nuveen & Co., Inc.*, 554 F.2d 790, 795 (7th Cir. 1977), the Seventh Circuit held that "[p]roof of scienter is unquestionably required as to [both] subsections 1 and 3 which specifically refer to fraud." The Second Circuit in *SEC* v. *Coven*, 581 F.2d 1020 (2d Cir. 1978), sought to avoid the plain import of the phrase in subsection (3) "operates as a fraud upon the purchaser." *Id.* at 1026. It construed this language "to focus attention on the *effect* of potentially misleading conduct on the public, not on the culpability of the person responsible." *Id.* Such an analysis ignores this Court's statement in *Hochfelder* that "logic of this effect oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support." 425 U.S. at 198.

Some courts have also attempted to pick and choose among the subsections of Section 17(a) suggesting that while Section 17(a)(1) and 17(a)(3) require a finding of scienter, Section 17(a)(2), which prohibits the obtaining of "money or property by means of any untrue statement of a material fact" without specifically referring to the word fraud, does not require proof of scienter. *See, e.g., SEC* v. *Steadman, supra.*

Such piecemeal statutory interpretation is plainly inconsistent with congressional intent as reflected in the title and in the opening provision of the section. It is inconsistent with this Court's holding in *Hochfelder* that the language of the comparable provisions of Rule 10b-5 cannot be "viewed in isolation." 425 U.S. at 212. It ignores the well-known doctrine of "ejusdem generis" (meaning "of the same kind or species") under which a broader

provision of the statute is limited and controlled by the specific statutory language. 2A Sutherland, *Statutes and Statutory Construction* §§ 47.17-.18 (4th ed. 1974). Further, segregating subsections (2) and (3) from the overall "fraud" direction of Section 17(a) on the theory that these subsections are directed to the effect rather than the culpability of conduct, is inconsistent with *Hochfelder's* rejection of such an approach as logically leading to the imposition of liability for "wholly faultless conduct." 425 U.S. at 198.

The correct approach is, we submit, as recently suggested by one commentator, "that sections 17(a)(1)-(3) have the same area of operation and were not intended to prohibit three distinct types of conduct. [Citations omitted.] Therefore the three clauses of Section 17(a) should be read together to convey one meaning, which is to proscribe fraudulent conduct, not mere negligence, thereby requiring proof of scienter."[1]

2. Legislative History of Section 17(a)

The legislative history plainly confirms that congressional intent in enacting Section 17(a) was to deal with "fraud" and not with negligence. The House Report which accompanied the bill containing the version of Section 17(a) which was ultimately adopted summarized the substance of the Commission's powers under the bill as follows:

> "The Commission may apply to the courts to enjoin any *device, scheme, or artifice to defraud, employed in connection with* the sale in interstate or foreign commerce of any securities, whether new or already outstanding." H.R. Rep. No. 85, 73d Cong., 1st Sess. 6 (1933). (Emphasis added.)

This is the only discussion of Section 17(a) in the reports, hearings or debates except for recitations of the statutory language.

The Second Circuit below in holding that negligence alone was sufficient for issuing an injunction under Section 17(a) relied almost exclusively on its earlier decision in *SEC* v. *Coven*, 581 F.2d at 1027, which in turn was largely based on a plain misreading of the legislative history. In *Coven* much is made of the fact the words "willfully" and "intent to defraud" appeared in the original Senate version of Section 17(a) and that the parallel House provision which contained no specific reference to intent was ultimately adopted. The Second Circuit concluded that Congress thereby "opted for liability without willfulness, intent to defraud or the like." *Id.*

The Conference Report strongly suggests, however, that the House version of Section 17(a) was adopted, not because it omitted specific reference to intent, but, for completely unrelated reasons relating to vicarious liabilities.[2]

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[1] R. Berner and R. Franklin, *Scienter and Securities Exchange Commission Rule 10b-5 Injunction Action: A Reappraisal in the Light of Hochfelder*, 51 N.Y.U. L. Rev. 769, 796-97 n.221 (1976).

[2] The Senate precursor of Section 17(a), introduced as Section 13 of S.875, made it unlawful to defraud a purchaser by employing or acting as a "dummy." The Conference Report explained that "[t]he Senate amendment contained provisions referred to as 'dummy provisions' which were calculated to place liability on a person who acted through another" and that "[t]he House bill did not contain such provisions." H.R. Conf. Rep. No. 152, 73rd Cong., 1st Sess. 27 (1933). The Conference Report noted that "[t]he various provisions of the Senate amendment on this subject have been welded into one and incorporated as a new section in the substitute"—*i.e.*, the present Section 15 of the 1933 Act imposing liability on controlling persons. *Id.*

The Conference Report begins with the statement that "differences between the House bill and the substitute agreed upon by the conferees *are noted in the following discussion*, except for incidental changes made necessary to harmonize various provisions effected by the agreements reached, and minor and clarifying changes to make clear and effective the administrative procedure provided for and to remove uncertainties." (Emphasis added.) H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 24 (1933). The Conference Report, however, makes no mention whatsoever of this supposedly important distinction between the House version of Section 17(a) which was adopted and the comparable provision in the Senate bill.

If Congress had intended, as the Second Circuit suggests in *Coven*, to opt "for liability without willfullness, intent to defraud or the like," 581 F.2d at 1027, this clearly would have been considered one of the substantive changes to be discussed in the Conference Report rather than an "incidental" or "harmonizing" modification. But the Conference Report contained no such discussion. The Conference Report evidently did not regard this to be a substantive change as characterized by the Second Circuit. As shown above, the House version adopted by the Conference was clearly written in terms of "fraud" which necessarily includes the element of scienter.

Furthermore, the fact the Conference Report specifically mentions that the choice between the Senate and House versions was made for an entirely different reason related to vicarious liability and makes no reference to the much more basic considerations suggested by the Second Circuit in *Coven*, is, we think, conclusive.

3. Structure of the 1933 and 1934 Acts

As this Court concluded in *Hochfelder*, "[i]t is thus evident that Congress fashioned standards of fault in the

express civil remedies in the 1933 and 1934 Acts on a particularized basis." 425 U.S. at 200.

For some conduct, Congress attached liability or other consequences without any fault. Section 11(a) of the 1933 Act imposes liability on the issuer for misleading statements in registration statements regardless of fault. Similarly, Section 8(d) of the 1933 Act, 15 U.S.C. §77h(d) (1976), authorizes the Commission to issue a stop order suspending the effectiveness of a registration statement containing a false and misleading statement regardless of whether it is intentional or inadvertent.

Other provisions impose liability only for failure to exercise reasonable care. Thus, Section 11(b)(3) of the 1933 Act imposes liability on experts such as accountants only upon a showing of failure to exercise reasonable care with respect to that portion of the registration statement for which they are responsible. Similarly, Section 12(2) of the 1933 Act limits liability by sellers of securities to knowing or negligent misrepresentations.

Under other provisions "good faith" is a complete defense—*i.e.*, with respect to liability under Section 18 of the 1934 Act, 15 U.S.C. § 78r (1976), for false statements in SEC filings or with respect to the liability under Section 20 of the 1934 Act, 15 U.S.C. § 78t (1976), of a controlling person for the acts of the controlled person.

Given this "particularized" statutory scheme, this Court said in *Hochfelder* that "ascertainment of congressional intent with respect to the standard of liability created by a particular section of the Acts must therefore rest primarily on the language of that section." 425 U.S. at 200.

As discussed above, the language of Section 17(a) is plainly directed towards fraudulent conduct. Liability for negligence, as Congress has specifically provided for other conduct, should therefore not be lightly implied. Congress has made the judgment to attach differing consequences to different types of conduct and has chosen not to attach

liability or other consequences to negligent conduct except as specifically provided in other provisions of the federal securities laws. This is not to say that other forms of negligent conduct may not be a matter of appropriate concern by the SEC. The fact is simply that Congress, in neither Section 17(a) of the 1933 Act nor Section 10(b) of the 1934 Act has chosen to deal with such a concern.

This Court stated in *Touche Ross & Co.* v. *Redington*, 99 S. Ct. at 2490, that "[t]he ultimate question is one of congressional intent, not one of whether this Court thinks it can improve upon the statutory scheme that Congress enacted into law." If the SEC feels that negligent conduct by broker-dealers or others is of sufficient concern to require remedies in addition to those Congress has authorized, the proper course is for the SEC to seek appropriate amendments to the 1933 and 1934 Acts to deal with such conduct.

Furthermore, whenever Congress in the 1933 and 1934 Acts has established liability for negligence, it, at the same time, defined the classes of persons who have a duty to exercise care, and the standard of care required to avoid liability.

Thus, Section 11(b)(3)(B)(C) provides that liabilities for untrue statements in registration statements shall be limited to defined classes of persons such as signatories of registration statements, officers, directors and experts. Moreover, it provides that no liability shall be imposed on a person who "shall sustain the burden of proof" that "he had, after reasonable investigation, reasonable ground to believe and did believe at the time such part of the registration statement became effective that the statements therein were true ...." Section 11(c) further provides that for purposes of determining "what constitutes reasonable investigation and reasonable gounds for belief, the standard of reasonableness shall be that

required of a prudent man in the management of his own property." Similarly, Section 12(2) of the 1933 Act imposes liability only on offerors and sellers of securities and only where the defendant is not able "to sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known of such untruth or omission."

Congress followed a similar approach in Section 15(b)(4)(E) of the 1934 Act which provides for the imposition of administrative sanctions on a broker-dealer who "has failed reasonably to supervise, with a view to preventing violations ... another person who commits such a violation." Sanctions can be imposed only "if such other person is subject to his supervision." Moreover, the statute provides that the requirement of reasonable supervision shall have been met if, *inter alia*, there are "established procedures which would reasonably be expected to prevent and detect" such violation and discharge by the supervisor of his duties under such procedures.

An interpretation of Section 17(a) authorizing the issuance of injunctive relief upon the basis of negligence alone would leave the courts without any comparable standards of duty or care or limitations on liability where compliance with minimum standards of care can be established. Congress, which neither in the 1933 Act nor in the 1934 Act imposed civil liability or administrative sanctions for negligence without the protections inherent in such standards and limitations, should not be assumed to have intended to do so in Section 17(a) of the same Act.

The Court noted in *Hochfelder* "[t]he 1933 and 1934 Acts constitute interrelated components of the federal regulatory scheme governing transactions in securities." 425 U.S. at 206. The construction of Rule 10(b) as requiring scienter in injunction actions and a contrary construction of the substantially identical language in Section 17(a) would create intolerable and unintended

dissymmetry in the statutory scheme of the 1933 and 1934 Acts. It would provide different standards of proof for identical types of conduct depending on the mere happenstance of whether a purchaser or a seller was defrauded. For example, if such differing interpretations were adopted a broker-dealer making an untrue pessimistic statement about the state of a company causing a customer to sell his shares could only be enjoined under a scienter standard while the same broker-dealer making optimistic statements causing a customer to buy shares could be subject to an injunction for mere negligence. Such a result would be contrary to the original intent of Rule 10b-5 to make the "fraud" provisions applicable equally to purchasers and sellers.

C. Section 21(d) of the 1934 Act and the Comparable Provisions of Section 20(b) of the 1933 Act Define and Limit the SEC's Injunctive Powers and Do Not Enlarge the Substantive Antifraud Provisions of the Act.

The Second Circuit in *Aaron* conceded that "the language of Section 10(b)—of course is the same regardless of whether the action is brought by the SEC or a private individual." 605 F.2d at 621. However, the Second Circuit "look[s] to § 21(d)" (*id.*) of the 1934 Act for a broadening of Rule 10b-5 to include merely negligent actions where an injunction rather than private damages are sought. The Second Circuit's reliance on Section 21(d), 15 U.S.C. § 78u(d) (1976), to achieve this result is entirely misplaced. Similarly, the substantially identical provisions of Section 20(b) of the 1933 Act, 15 U.S.C. § 77t(b)(1976), do not broaden the scope of Section 17(a) of that Act.

As this Court recently emphasized in construing the statutory authority of the Commission under the 1934 Act "[t]he first and most salient point . . . is the language of the statute." *SEC* v. *Sloan*, 436 U.S. 103, 111 (1978).

The express language of Section 21(d) limits the statutory authority of the Commission to invoke the equity jurisdiction of the United States only in circumstances where "it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the Act or any rules promulgated thereunder." Section 21(d) does not contain the slightest indication that it is intended to modify for purposes of SEC injunction action the clear "fraud" language in Section 17(a), Section 10(b) and Rule 10b-5.

Absent any support in the language of Section 21(d) the Second Circuit cites as its only support in the legislative history the same legislative history on which it relied in *Coven* for its holding that no scienter is required under Section 17(a). The Second Circuit's argument is that the Congress in adopting the House version of Section 17(a) of the 1933 Act and rejecting a Senate version which had a specific reference to intent "clearly indicated its rejection of a scienter standard for injunctive relief." 605 U.S. at 622 n. 14. This same rejection, so the argument appears to go, carries over into Section 20(b) of the 1933 Act and from there to Section 21(d) of the 1934 Act. As discussed above, the basic premise of this convoluted argument is erroneous. The legislative history—*i.e.*, the Conference Report—makes it quite clear that the choice between the House and Senate versions of Section 17(a) was not predicated upon any determination to reject the scienter standard for injunctive relief but on other unrelated grounds.[3]

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[3] No other support is cited by the Second Circuit for its decision except for the so-called "legislative discussion" in 1975 when Section 21(d) was neither enacted nor amended in any substantive manner but merely renumbered. No weight may be attached to such legislative discussion for the reasons set forth in the AICPA Brief at 14-15.

D. The Elimination of the Scienter Requirements in SEC Injunction Actions Under the Antifraud Provisions Would Circumvent the Specific Statutory Requirements of Section 15(b) of the 1934 Act.

Section 15(b)(4) of the 1934 Act empowers the Commission to impose administrative disciplinary sanctions of a most serious nature on broker-dealers. Such sanctions include censure, limitations on the activities, functions or operations of the broker-dealer, or a suspension or ultimately a revocation of the broker-dealer's registration, depriving him of the right to continue in business. Such sanctions, however, when based on violations of the antifraud provisions, "result in stigmatizing the defendant irrespective of the formal sentence meted out." *Whitney* v. *SEC*, 604 F.2d 676, 681 (D.C. Cir. 1979).

Such sanctions—to the extent they are based upon violations of the antifraud provisions of the federal securities laws—may be imposed upon a broker-dealer through two differing avenues:

> (1) on the basis of a finding after an evidentiary hearing that the broker-dealer "willfully" violated or "willfully" aided and abetted a violation of the federal securities laws, or
>
> (2) on the basis that the broker-dealer is permanently enjoined from engaging in or continuing any conduct in connection with the purchase or sale of any security, or is convicted of certain crimes. See Section 15(b)(4).

If the Commission initiates an administrative proceeding under Section 15(b)(4) without first obtaining injunctive relief, it could not impose administrative sanctions for violations of the antifraud provisions in the

absence of a finding of willful misconduct. As the D.C. Circuit recently stated in *Whitney* v. *SEC:*

> "Section 15(b) by its terms requires that a person have 'willfully' violated the securities laws, [citation omitted], and we think 'willfullness' in this sense is more or less congruent with *Hochfelder's* use of 'scienter'." 604 F.2d at 682 n.23.

However, if scienter were to be eliminated from the requirements for injunctive relief under the antifraud statutes, the Commission could easily short-circuit the clear purpose and intent of Section 15(b) by obtaining an injunction based on negligence in a federal court and then on the basis of that injunction alone imposing administrative sanctions on the broker-dealer.[4]

Furthermore, congressional intent generally to limit the imposition of administrative sanctions to cases of willful conduct is confirmed by a 1964 amendment to Section 15(b). This amendment, Section 15(b)(4)(E), provides for the imposition of sanctions upon finding that a broker-dealer "has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation if such other person is subject to his supervision." Compliance with established and adequate supervisory procedures is a complete defense to any charges of negligence under this provision.

This carefully circumscribed provision is the first and *only* case where Congress has permitted the SEC to impose

[4] The purpose of the provision authorizing the SEC to impose sanctions on the basis of a prior injunction is clearly not to impose an alternative standard of liability but merely to avoid the need to relitigate in the administrative proceedings issues already decided in a court proceeding.

on broker-dealers administrative sanctions on the basis of conduct other than willful. It is significant that at the same time that Congress adopted this provision, it added as a part of the same subsection as further ground for the imposition of administrative sanctions a finding that the respondent "has willfully aided, abetted, counseled, commanded, induced or procured" the violation of any of the federal securities laws. Congress thus made a clear distinction between willful conduct in one case and negligent conduct in the other. Moreover, the need to amend Section 15(b)(4) to include failure to supervise as a separate ground for sanctions reflects congressional recognition that such failure reasonably to supervise would not constitute a willful violation of the antifraud provisions of the 1933 and 1934 Acts for the purposes of imposing administrative sanctions.[5]

[5] The congressional action specifically authorizing the imposition of the administrative sanctions for a failure reasonably to supervise does not imply a general congressional willingness to permit such sanctions to be imposed for negligent conduct. The District of Columbia Circuit in *Whitney* v. *SEC*, 604 F.2d at 681, recognized a very real distinction between the special "stigmatizing" effect of sanctions imposed for violations of the antifraud provisions and sanctions imposed on other grounds. It therefore held that every sanction imposed under Section 15(b) which depends on a finding of fraud must be sustained by clear and convincing evidence as distinct from the mere preponderance of the evidence which will suffice to sustain sanctions on other grounds.

II. THE AVAILABILITY AND ISSUANCE OF INJUNCTIVE RELIEF IS GOVERNED BY ESTABLISHED EQUITABLE PRINCIPLES

A. The Potent Weapon of Injunctive Relief Is Available Only Where There Is A Need To Deter Future Unlawful Conduct and Where the Public Interest Outweighs Countervailing Private Needs.

Sections 20(b) of the 1933 Act and 21(d) of the 1934 Act, by invoking the equity jurisdiction of the courts, bring into play established equitable principles limiting and governing the use of the Court's equitable powers. This Court's decision in *Hecht Co.* v. *Bowles*, 321 U.S. 321 (1944), recently reaffirmed in *Rondeau* v. *Mosinee Paper Co.*, 422 U.S. 49 (1975), makes it very clear that federal regulatory statutes providing for injunctive relief do not override these underlying equitable principles but must be construed in accordance therewith.

In *Hecht* v. *Bowles*, the regulatory provision involved was Section 205 of the Emergency Price Control Act of 1942 which provided that upon a showing that a person "has engaged or is about to engage" in practices violating the statute a "permanent or temporary injunction, restraining order or other order shall be granted." 321 U.S. at 322. The Price Administrator therefore contended that upon a showing of any violation of that Act the issuance of an injunction was mandatory. This Court, however, clearly rejected that contention as being a "drastic departure from the traditions of equity practice" "with a backgound of several hundred years of history" which it would not imply absent an unequivocable statement of congressional purpose. *Id.* at 329. This Court added:

> "The historic injunctive process was designed to deter, not to punish. The essence of equity jurisdiction has been the power of the Chancellor to do equity and to

mould each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it. The qualities of mercy and practicality have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims. We do not believe that such a major departure from that long tradition as is here proposed should be lightly implied." *Id.* at 329-30.

Applying these principles this Court reversed a lower court order granting an injunction against the department store even though "numerous violations" of that regulation were discovered, because the violative pricing actions were all made "in good faith and without intent to violate the regulations" (*id.* at 324-25), and vigorous steps were taken to prevent their recurrence.

This Court's decision in *Hecht* v. *Bowles* reaffirms established equitable principles of obvious relevance here—*i.e.*, that injunctions will be issued by a court of equity only if necessary and appropriate to "deter" future violative conduct, and not to punish a defendant by tagging him with an injunction, and that Courts will not perfunctorily issue unnecessary injunctions even if seemingly required by the literal language of the regulatory statute.[6]

Moreover, in *Hecht* this Court held that in determining whether or not to grant an injunction, the courts must make a "nice adjustment and reconciliation between public interest and private needs." *Id.* at 329. In *Aaron*

[6] As noted above, the Act involved in *Hecht* v. *Bowles* provided for the issuance of an injunction upon a showing that a person "has engaged or is about to engage in violative conduct." In contrast, Section 21(d) of the 1934 Act and Section 20(b) of the 1933 Act require that the SEC, as a prerequisite for the issuance of an injunction, prove that the defendant "is engaged or about to engage" in violations of the 1933 and 1934 Acts.

the Second Circuit made short shrift of the need to balance the public interest and private needs, stating that its "view that the increased effectiveness of government enforcement actions predicated on a showing of negligence alone outweighed the danger of potential harm to those enjoined from violating the securities laws." 605 F.2d at 621.

B. The Harmful Consequences of Subjecting Broker-Dealers and Other Persons to Injunction Actions Based on Negligence Alone Far Outweigh the Countervailing Public Interest Served By Such an Extension of the SEC's Injunctive Powers.

The potential adverse impact, especially on broker-dealers, of eliminating the scienter requirement in SEC injunction actions under the antifraud provisions may be summarized briefly as follows:

1. Proliferation of SEC Injunction Actions

If the SEC could prevail in an injunction action on a finding of negligence alone, it must be assumed that the SEC would institute an injunctive proceeding under the antifraud provisions in more cases and on the basis of less evidence that it does so today. In the securities business, where so much is necessarily based on trust and reputation, the institution of an SEC injunction action under the antifraud provisions of the 1933 and 1934 Acts can have very serious consequences for any broker-dealer. Such complaints filed by the SEC would, in the normal course, as it did in this case, allege intentional conduct (even though the action is actually grounded on negligence). Moreover, in any event the press in their reports will not make such distinctions and will announce that a brokerage firm or individual broker-dealer has been the subject of "SEC fraud charges." Even an ultimate finding of innocence,

after long and costly litigation, cannot undo the impact of such adverse publicity. In *Securities Investor Protection Corp.* v. *Barbour*, 421 U.S. 412 (1975), this Court stated that:

> "Except with respect to the solidest of [brokerage] houses, the mere filing of an action predicated upon allegations of financial insecurity might often prove fatal." *Id.* at 422.

This Court itself compared the SIPC proceedings to administrative broker-dealer proceedings under the 1934 Act.[7]

2. Increased SEC Leverage in Settlements of Enforcement Actions

Most SEC injunction actions against broker-dealers as against other defendants are settled without a trial on the merits. Any settlement of an injunction action against a broker-dealer necessarily involves a resolution of the administrative sanctions which by reason of the consent injunction the SEC could impose upon the broker-dealer. The adoption of the negligence standard, by lowering the standard of proof required in SEC injunction actions, would give the SEC additional leverage to extract from defendant broker-dealers not only broad injunctions similar to that issued in this case, but at the same time to insist on the acceptance of harsh administrative sanctions. These considerations are of unusual importance since few broker-dealers have the resources or stamina to engage in

[7] The Court's opinion, quotes from Freeman, *Administrative Procedures*, 22 Business Lawyer 891, 897 (1967):

> "'The moment you bring a public proceeding against a broker-dealer who depends upon public confidence in his reputation, he is to all intents and purposes out of business.'" 421 U.S. at 422 n.5.

extended litigation with the SEC, and also little inclination to litigate with the government agency which has broad regulatory powers over them on a regular basis.

3. Impact of Injunction

In the event that after a trial or settlement an injunction is issued on the basis of negligence alone, the adverse impact is magnified. The issuance of an antifraud injunction permanently mars the record and reputation of a broker-dealer. Neither the press nor customers are likely to make differentiations between antifraud injunctions granted on a finding of negligence alone or on a finding of scienter. Fraud, certainly in ordinary parlance, connotes "scienter."

Moreover, "the real sanction of the injunction arises from the fact that from that point on defendants proceed at their peril and that without indictment and without a jury trial, they may incur criminal sanctions in the event of further sales deemed to be a violation of . . . the fraud provisions." 3A Blumenthal, *Securities and Federal Corporate Law*, § 8.02[3] at 8-12 (1976 rev.), quoted in *SEC* v. *Cenco, Inc.*, 436 F. Supp. 193, 198 (N.D. Ill. 1977).

The risk inherent in any injunction is substantially increased by the broad scope of the injunction in this case which applies, without limit to each and every violation of the antifraud provisions. The antifraud provisions themselves are so broad as to comprehend not only the violation of many other provisions of the federal securities laws, but also a broad range of conduct which in the rapidly evolving interpretation of these provisions may in the future be deemed to be fraudulent.

4. Collateral Administrative Consequences

As discussed above, mere issuance of an injunction, be it for negligence or otherwise, triggers the provisions of Section 15(b) which permits the Commission, based solely

upon the issuance of an injunction, to impose severe administrative sanctions on broker-dealers or associated persons. While the Commission is subject to some judicial review in its assessment of a sanction, the Commission has broad discretion to impose such administrative sanctions once a broker-dealer has become subject to an injunction.

The issuance of an injunction also has other collateral consequences which can have a serious impact on a broker-dealer or associated persons.[8]

C. No Valid Enforcement Purpose Is Served By Issuing An Injunction On the Basis of Negligence Alone

Balanced against the grave consequences and serious ramifications of an injunction, particularly one issued against a broker-dealer, there is little if anything to be gained, in terms of SEC enforcement policy, by providing for issuance of antifraud injunctions on a finding of mere negligence alone.

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[8] For example, the Regulation A exemption from registration for the sale of securities by an issuer not exceeding $1,500,000 is, under Rule 252(c)(4) of Regulation A, 17 C.F.R. §230.250(c)(4) (1979), not available if, among others, any of the officers or directors of the issuer, the underwriter or any of the underwriter's officers or directors have been enjoined on the basis of a securities law violation. The unavailability of the Regulation A exemption may have a serious impact on the underwriting business of a broker-dealer.

Section 9(a)(2) of the Investment Company Act of 1940, 15 U.S.C. §80a-9(a)(2) (1976), bars any person who is subject to an injunction from serving as an employee, officer or director of an investment company.

Pursuant to Regulation S-K, item 3(f)(3), 17 C.F.R. §229, 20.3(f)(3) (1979), a corporation in its annual report filed with the SEC, its proxy statement and is any registration statement, is required to disclose any SEC injunction entered against any director or executive officer within the last five years.

The ultimate deterrent of an injunctive order is the criminal contempt power of the courts. The anomaly of an antifraud injunction issued on the basis of a finding of negligence is that it would appear that the subject of the injunction could not be found in criminal contempt for negligent conduct—the only type of conduct which gave rise to and which should therefore be deterred by the injunction. It is well established that a person will be held to be in criminal contempt of an injunction only upon a finding of willfullness—*i.e.*, actions which are "deliberate, voluntary or intentional as distinguished from accidental, inadvertent or negligent." *United States* v. *Fidanian*, 465 F.2d 755, 760 (5th Cir. 1972), *cert. denied*, 409 U.S. 1044 (1972).[9]

In any event, an injunction is, at best, of questionable effect to prevent a broad range of unspecified negligent conduct, conduct which by definition is unintentional. Furthermore, since a propensity to commit intentional acts of fraud or deceit hardly can be inferred from negligent conduct, no valid enforcement purpose or need is served by the injunction to the extent that it seeks to enjoin fraudulent, in addition to negligent, conduct.

III. THIS COURT SHOULD INSTRUCT THE LOWER COURTS AS TO THE APPROPRIATE STANDARDS AND FORM OF INJUNCTIVE RELIEF

This Court, on remand, should give the lower courts directions on important issues relating to the standards for determining if any injunction is appropriate under Section 21(d) of the 1934 Act or Section 20(b) of the 1933 Act and the form of injunctive relief to be granted.

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[9] *See also United States* v. *Prugh*, 479 F.2d 611 (8th Cir. 1973); *United States* v. *Custer Channel Wing Corp.*, 376 F.2d 675 (4th Cir.), *cert. denied*, 389 U.S. 850 (1967); Note, *Developments in the Law—Injunctions*, 78 Harv. L. Rev. 994, 1086 (1965).

A. The Applicable Standards for Injunctive Relief under Section 20(b) of the 1933 Act and Section 21(d) of the 1934 Act

As discussed in Section I.C above, Section 21(d) of the 1934 Act and the comparable provisions of Section 20(b) of the 1933 Act establish prerequisites for injunctive relief in addition to a finding of a substantive violation in the past. They require a determination that the defendant "is engaged or about to engage in violative conduct."

The District Court based its finding that there is "a likelihood of Peter Aaron's further violations of these securities laws in the future" largely on the fact that "while not presently in the securities business," he "clearly expressed at trial a strong interest in returning to the securities industry," *SEC* v. *E. L. Aaron & Co., Inc.*, Fed. Sec. L. Rep. (CCH) ¶96,043 at 91,686. The District Court apparently felt that this "strong interest" was enough to constitute a threat of future violations even though Aaron & Co., the firm at which the failure to supervise occurred, was "no longer doing business" and LAM, the company about which the misrepresentations were made by the two registered representatives found to have been under Mr. Aaron's supervision, was in bankruptcy. *Id.* at 91,682.

The District Court, in deciding to grant injunctive relief, considered the nature and extent of the violations, and the "defendant's failure to recognize the wrongful nature of his conduct." *See* Order Granting Injunction in *SEC* v. *E. L. Aaron & Co., Inc.*

The Second Circuit affirmed the issuance of the injunction on a similar basis.

The SIA takes no position whether on remand and on a finding of scienter an injunction should issue against Mr. Aaron. The SIA, however, is concerned that the courts limit the issuance of injunctive relief to cases where the required showing of ongoing or future violations is made.

The federal courts have in the past been inclined to grant injunctive relief largely on the theory that a threat of further violations may be inferred from past conduct. However, some recent cases show an increasing realization that the SEC must come forward with "positive proof" to "demonstrate realistic likehood of recurrence." *SEC* v. *Commonwealth Chemical Securities*, 574 F.2d 90, 100 (2d Cir. 1978); *SEC* v. *Bausch & Lomb*, 565 F.2d 8, 18 (2d Cir. 1977). In a number of recent SEC injunction cases, courts have denied injunctive relief even though violations of the antifraud provisions of the federal securities laws were found, in the absence of a requisite proof of a threat of future wrongdoing. *See, e.g., SEC* v. *Wills*, Fed. Sec. L. Rep. (CCH) ¶96,712 (D.D.C. 1978); *SEC* v. *National Student Marketing*, 430 F. Supp. 639 (D.D.C. 1977); *SEC* v. *Cenco*, 436 F. Supp. 193, 198 (N.D. Ill. 1977).

It is clear that Congress intended to limit the issuance of an injunction to restrain ongoing and threatened violations. Senate Report No. 47, 47th Cong., 1st Sess. 6 (1933), explained that the Government was given the right to seek an injunction so that it could "stop the further or threatened fraud or misrepresentation." Earlier versions of the 1933 Act which did include language permitting resort to injunctions based upon investigative findings of only past misconduct were discarded prior to enactment. *See* Section 13 of H.R. 4314 and S. 875 and Section 20 of H.R. 5480, 73d Cong., 1st Sess. (1933). Furthermore, Congress has repeatedly rejected attempts by the Commission to expand its powers under the Act to be permitted to file for injunctions upon the basis of past misconduct alone, most recently in 1975. *Five Securities Lawyers To Conferees On Proposed Change Of '34 Act.*

§ *21(e)*, 302 Sec. Reg. & L. Rep. (BNA) H-1 (May 14, 1975) and H.R. Rep. No. 229, 94th Cong., 1st Sess. 102 (1975).[10]

The limitation of the SEC injunctive powers to their intended function of protecting the investing public from ongoing or real threats of future violations will not leave the SEC without power to deal with past violations. As noted above, the 1933 and 1934 Acts provide amply for punishment of past violators through criminal penalties, administrative sanctions and civil damages.

The proper standard for the issuance of injunctive relief under the antifraud provisions of the federal securities laws is currently and continually at issue in the federal courts. This Court should use this opportunity to give the lower courts guidance on the proper prerequisites

[10] In 1941, 1956, 1957, and 1959, the Commission unsuccessfully sought to amend the 1933 and 1934 Acts to allow the Commission to obtain an injunction only upon a showing of past illegal conduct. *See Hearings on Proposed Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934 Before House Committee on Interstate and Foreign Commerce*, 77th Cong., 1st Sess. 875 (1941); Section 227 of H.R. 11129, 84th Cong., 2d Sess. (1966); Section 9 of S. 2544, 85th Cong., 1st Sess. reported in 103 Cong. Rec. 11631 (1957); Section 7 of S. 1178, reported in *Hearings Before Subcomm. of the Senate Comm. on Banking and Currency*, 86th Cong., 1st Sess. 252 (1959). Each of the proposed bills would have added the "has engaged" language, and changed the "proper showing" standard for the issuance of an injunction to a showing "that such person has engaged, is engaged, or is about to engage" in an illegal act.

See S. Rep. No. 1756, 86th Cong., 2d Sess. 4 (1960). In 1975, the Commission sought to add the "has engaged" language to the Acts, and to change "proper showing" to "such a showing." *See* Section 16(b) of S. 249, 94th Cong., 1st Sess. 32 (1975). The proposed changes were deleted in conference. H.R. Rep. No. 229, 94th Cong., 1st Sess. 102 (1975).

for such injunctive relief, particularly since such guidance will be necessary in this case, if, as we urge, a remand is required.

B. The Injunction Issued Here Does Not Comply With the Requirements of Specificity and Reasonable Detail Under Rule 65(d).

The injunction issued in this case is broadly written in the statutory language of Section 17(a) and the regulatory provisions of Rule 10b-5. It provides that:

> "IT IS FURTHER ORDERED, ADJUDGED AND DECREED that the defendant Peter E. Aaron, his agents, servants, employees, attorneys and those persons in active concert or participation with him, and each of them, be and hereby are permanently enjoined from, directly or indirectly, by the use of any means or instrumentality of transportation or communication in interstate commerce or of the mails, in connection with the offer for sale, sale, offer to purchase, or purchase of the common stock of Lawn-A-Mat Chemical & Equipment Corp., or any other securities:
>
> "(1) employing any device, scheme or artifice to defraud;
>
> "(2) obtaining money or property by means of or otherwise making any untrue statement of a material fact or omitting to state a material fact necessary, in order to make the statements made in light of the circumstances under which they were made, not misleading; or
>
> "(3) engaging in any act, transaction, practice or course of business which operates or would operate as a fraud or deceipt upon any person."

The injunction, in its lack of specificity, is plainly inconsistent with the requirements of Rule 65(d) of the Federal Rules of Civil Procedure which provides in relevant part:

> "Every order granting an injunction ... shall set forth the reasons for its issuance; shall be specific in terms; shall describe in reasonable detail ... the act or acts sought to be restrained ...."

Mr. Justice Stewart stated in *Schmidt* v. *Lessard*, 414 U.S. 473, 476 (1974):

> "As we have emphasized in the past, the specificity provisions of Rule 65(d) are no mere technical requirements. The Rule was designed to prevent uncertainty and confusion on the part of those faced with injunctive orders, and to avoid the possible founding of a contempt citation on a decree too vague to be understood ... [s]ince an injunctive order prohibits conduct under threat of judicial punishment, basic fairness requires that those enjoined receive explicit notice of precisely what conduct is outlawed."

Earlier this Court stated in *International Longshoresmen Association* v. *Philadelphia Marine Trade Association*, 389 U.S. 64, 76 (1967):

> "The judicial contempt power is a potent weapon. When it is founded upon a decree too vague to be understood, it can be a deadly one.[11]

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[11] Recently, this Court reiterated the importance of complying with Rule 65(d) in *Pasadena City Board of Education* v. *Spangler*, 427 U.S. 424, 439 (1976):

> "Because of the rightly serious view courts have traditionally taken of violations of injunctive orders, and because of the severity of punishment which may be imposed for such violation, such orders must in compliance with Rule 65 be specific and reasonably detailed."

In *National Labor Relations Board* v. *Express Publishing Co.*, 312 U.S. 426, 432 (1941) this Court struck down an order enjoining respondents in an NLRB proceeding from violating "in any manner the duties imposed on the employer imposed by the statute" based upon a single violation of one particular provision of the statute. The analogy to the decree in this case is clear. Yet this Court stated:

> "[T]he mere fact that the court has found that a defendant has committed an act in violation of a statute does not justify an injunction broadly to obey the statute and then subject the defendant to contempt proceedings if he shall at any time in the future commit some new violations unlike and unrelated to that with which he was originally charged." *Id.* at 435-36.

It may be that some statutory provisions themselves are specific enough so that an injunction stated merely in statutory terms could meet the requirements for specificity. However, Section 17(a) of the 1933 Act and Rule 10b-5 are "catch-all" provisions and, relating as they do to any conduct in connection with the sale, offer or purchase of securities which may be deemed to be fraudulent, clearly lack the required specificity. To expose a defendant to criminal contempt for any conceivable violation of these provisions is plainly inconsistent with the "basic fairness" requirements incorporated in Rule 65(d).

Lower courts have admittedly been prone to issue such broad injunctions at the behest of the SEC. Moreover, in many settlements the SEC has insisted on and obtained such broad relief. Such far-ranging injunctions, however, are, we submit, contrary to the consistent line of decisions of this Court requiring specificity of the conduct to be restrained.

In contrast to the broad injunction in this case, in *SEC* v. *Capital Gains Bureau*, 375 U.S. 180, 193 (1963), the preliminary injunction affirmed by this Court was discretely limited to specific conduct—"requiring a fiduciary to disclose to his clients, not all his security holdings, but only his dealings in recommended securities just before and after the issuance of his recommendations."

A broad injunction such as issued here is not only unfair in that it subjects a defendant to criminal contempt on too vague a command, but its very vagueness greatly reduces its effectiveness as an enforcement tool.

An injunction prohibiting or requiring certain specified conduct gives the defendant a clear direction as to what he should or should not do to prevent future violations of the statute. In contrast, an injunction phrased in the broad statutory or regulatory terms of Section 17(a) and Rule 10b-5 is essentially redundant in that it simply prohibits violation of law. The only effect of such an injunction, if valid, is to add a possible criminal contempt remedy to the substantive criminal penalties already imposed by the 1933 and 1934 Acts. It does not focus the criminal contempt remedy on certain conduct more specific than the general terms of the statute.

Accordingly, on remand this Court should instruct the lower courts to limit any injunction which may be issued to specific conduct reasonably related to the violations of which defendant Aaron may be found to have committed.

CONCLUSION

The Opinion of the Second Circuit should be reversed and remanded for further proceedings for application of the scienter standard with instructions as to the proper prerequisites for, and form of, injunctive relief.

Respectfully submitted,

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